

COMBATING THE CABLE CABAL:

How to Fix America's Broken Video Market

S. Derek Turner

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EXECUTIVE SUMMARY

Two decades ago, something unusual happened.

Consumers were irate about their cable bills, which were increasing at nearly three times the rate of inflation. And Congress actually did something — adopting in overwhelmingly bipartisan fashion the 1992 Cable Act. The law resulted in lower cable bills, saving consumers \$3 billion in just over a year's time.

But this was only a brief respite. Washington soon caught a deregulatory fever, and less than three years after a super-majority of Congress voted to rein in monopoly cable prices, an even larger super-majority voted to let the cable industry return to its price-gouging ways. And return to them it did. Since 1996, cable bills have continued to increase at nearly three times the rate of inflation.

This trend is only getting worse. Since the 2008 recession, the average annual rate of inflation has been 1.4 percent, but the price of expanded basic cable service has increased by an annual average of 5 percent. And these figures don't include mandatory equipment-rental costs, which continue to skyrocket.

Perhaps even more alarming is the fact that the limited amount of video competition the 1992 Cable Act helped foster is doing nothing to discipline prices.

While no one is willing to take credit for these out-of-control price increases, there is plenty of blame to go around. Cable channel owners such as Disney and News Corp., and multichannel distributors like Comcast and Time Warner Cable, are the two factions of a comfortable cabal, one that earns monopoly-level profits from consumers who are deprived of any real choice in the pay-TV market.

The Multichannel Distributors: Happy, Profitable Middlemen

- From 2007–2011, a time when the American economy struggled mightily, the multichannel distributors collectively increased the price of expanded basic cable service by 22 percent.
- These rate hikes and other fee increases helped the industry increase video-segment revenues by 27 percent, an impressive performance considering that during this period there was almost no growth in the total number of multichannel video subscribers. Indeed, the traditional wired cable providers' total video revenues grew by 11 percent during this period — even though these companies lost 11 percent of their subscribers during this timeframe.
- The video market problem is ultimately a broadband market problem. The video market's failures are spilling over into the broadband market, threatening our national policy goals of creating affordable, universally available broadband communications infrastructure.
 - Rising programming fees are squeezing all distributors' video-profit margins. But because the wired providers bundle broadband with video, they are able to cross-subsidize their declining video profits with broadband, a hugely profitable service that is subject to little competition.
 - From 2007–2012, Comcast's video margins declined by one-fifth. But because it was able to increase its data-segment margins, the company's total profits increased.
 - This cross-subsidy is facilitating the cable industry's inefficient business model of artificial bandwidth scarcity. Despite consuming on average just 5 percent of the cable system's capacity, high-speed data services account for more than one-fourth of the cable industry's revenues.

The Programmers: Making You Pay More for More of What You Don't Want

- As impressive as the multichannel video distributors' fiscal performance was through the recent economic downturn, it pales in comparison to the growth enjoyed by cable programmers.
 - From 2007–2011, total cable-programmer revenues grew by 36 percent, a result analyst firm SNL Kagan characterized as “pretty impressive given the brutal recession that we were in during this period.”
 - From 1992–2011, the programming industry's collective operating profit margin increased from 24 percent to 41 percent. During this period, the industry's profits increased 10-fold in real value, to \$20 billion at the end of 2011.
 - While the programmers' own costs are increasing, they are more than making up for it with higher carriage fees. From 1992–2000, the programmers increased the licensing fees they charge distributors at the same rate their own expenses grew. But since the turn of the century, the programmers have exercised their pricing power and increased licensing fees at a higher rate than their own costs are rising.
- The broadcasters are now joining the cable channels in treating multichannel subscribers like ATMs.
 - The broadcast industry as a whole has seen retransmission revenues — the fees cable companies pay broadcasters to carry their channels — increase more than 10-fold in just the past six years alone, from \$215 million in 2006 to \$2.4 billion in 2012.
 - In 2006, retransmission fees contributed just 1 percent of broadcast revenues. That figure is now 9 percent. In 2012, retransmission contributed 19 percent of News Corp.'s broadcasting revenues, up from 11 percent just two years earlier.
- These broadcasting and cable channel carriage-fee increases have come even as many broadcast and cable networks have lost viewers.
 - Nine of the 25 most-watched cable networks experienced a decline in primetime viewership over the past decade, yet all increased per-subscriber licensing fees. Six of these nine channels enjoyed higher profit margins despite losing audience share.
- The programming business is particularly profitable for network owners who can leverage their ownership of must-have channels to force multichannel distributors to purchase much less profitable channels.
 - Because the fees that programmers charge are not directly related to the viewing audience's size, they can earn healthy profit margins simply by repackaging low-cost content and forcing distributors to carry these low-demand channels on the basic tier. In 2011, more than half of the 20 most profitable networks (measured by profit margin) were not ranked among the 20 most-watched channels.
 - The industry tells consumers that this bloating of the basic tier represents more value. But viewing habits suggest otherwise. In 1995, the average multichannel household received 41 channels, but tuned into only 11. In 2008 (the last year Nielsen reported this data), the average multichannel household tuned into only 18 of the 130 channels received.

- Sports networks are a key source of the runaway growth in consumers' monthly bills.
 - Sports networks account for nine of the 10 worst value-delivering channels (where value is a measurement of the ratio of a channel's total licensing fees divided by its audience size). For example, News Corp.'s Fuel TV has one of the smallest audiences among rated networks yet reaps per-subscriber licensing fees that are greater than those earned by half of all rated channels.
 - In 1995, sports networks accounted for 17 percent of the license fees paid to cable programmers. Today that figure stands at 38 percent. In some markets with a large number of Regional Sports Networks (RSNs), sports channels account for more than 50 percent of a subscriber's monthly TV bill.

The Viewers: We've Had Enough

- Americans love their TVs, but these price increases have many saying enough is enough. In 2009, the penetration of traditional TV subscription services peaked at 88 percent of households, and has declined slightly every year since.
- The media have devoted much attention to so-called "cord cutters" who are dumping multichannel subscriptions for online content. But the real sea change in this market is how all consumers are displacing traditional linear channel viewing with online and time-shifted content.
 - According to Nielsen estimates for the last half of 2012, though we are all spending more time in front of a screen, we are watching less live television. For those in the advertiser-coveted 18-to-34-year-old demographic, traditional TV watching accounted for less than 60 percent of total daily screen time, substantially below the level seen in older age groups.
 - Those in the narrower 18-to-24-year-old demographic spend approximately 30 percent of their daily screen time on the Internet, with more than one-tenth of their total screen time spent watching online or mobile video content. In the second half of 2012 alone, the time this age group spent watching online video (fixed and mobile) increased by 32 percent.
 - While this trend is strongest among youth, online video viewing is increasing for all Americans. For the population as a whole, the time spent watching online video increased by 17 percent, from 11.2 hours each week in the middle of 2012 to 13.1 weekly hours by the end of 2012.
- It's tempting to view this shift as a natural market evolution. However, disruption of the status quo will be impossible if programmers and distributors continue to take steps to block the over-the-top competitive threat to their traditional multichannel model.

Market Failures Here, There and Everywhere

The video market is broken. Market failures are everywhere:

- There isn't enough viable competition to discipline the market power enjoyed by large programmers and distributors, which hike prices without any fear of losing profits. Both sides in this increasingly distrustful union use contractual obligations to keep the cabal together, erecting artificial entry barriers for new players and restraining trade that would otherwise occur in a free market.
- Large programmers tie unpopular channels to marquee networks, crowding out capacity and financial resources for independent channels.

- Principal-agent problems ensure consumers have little sovereignty when it comes to translating their demands into the products available in the market. A distributor like Comcast protects its interests, not its subscribers', when negotiating channel carriage contracts.
- Distributors use broadband (a product facing very little competition in a market with insurmountable entry barriers) to cross-subsidize their high-revenue video business.
- Some large distributors like Comcast actually use predatory pricing (e.g., selling a video-data bundle for less than the price of stand-alone data service) to discourage competition from new video providers.
- Distributors also use data caps and threats against Internet openness to thwart competition from over-the-top competitors.
- Hidden prices are the most tangible sign of a failed market:
 - Distributors sell inflexible, more-than-you-can-eat programming bundles full of linear channels spanning numerous genres, procured at vastly different prices from programmers. This model makes consumers appear far less sensitive to price increases than they actually are for any given channel or group of channels.
 - These hidden prices ensure that efficient market equilibrium is never reached: Supply can never meet demand because consumers aren't allowed to express that demand.
 - Hidden prices explain why a channel like Lifetime can lose two-thirds of its audience while maintaining an operating profit margin nearly three times that earned by Exxon Mobil.
- The multichannel market's hidden prices thrive because of the bundled-channel business model. But bundles aren't inherently bad. What's harmful is the lack of choice offered among these multichannel bundles. Consumers are given a choice only between very little and far too much. In a competitive market, this all-or-little approach would not survive. It's as if you walked into a local deli and your only choices were a ham sandwich on rye — or a sub with every kind of meat, cheese, bread, topping and condiment imaginable.

So Many Problems ... One Big Answer

Policymakers used to have it much easier. Cable was the video monopoly, so Congress took action to rein in that monopoly power and facilitate entry by new distributors. We've now gone from one to in some cases five multichannel distributors, yet this increase in the number of providers is doing nothing to keep down prices or spur innovation in the video-distribution market.

Consumers want content and are willing to pay a fair price for it, but they aren't happy with the bloated options the multichannel distributor/programming cabal offer. New over-the-top distributors are eager to enter the market, but many find it difficult to obtain programming at a fair price — or at all. The millions of consumers who have opted out of the traditional multichannel market are a motivated and technically sophisticated bunch, but their numbers will remain small if nothing is done about the video market's many failures.

Unless policymakers confront those problems, consumers should expect more rate increases at three times the pace of inflation. Unless Washington gets serious about fostering a truly competitive market, consumers looking to online video alternatives should expect an incomplete, cumbersome and ultimately unsatisfying alternative to the status quo. And until policymakers confront the Federal Communications Commission's failures to adequately implement Congress' blueprint for competition embodied in the 1996 Telecommunications Act, we should gird ourselves for a cable-modem monopoly — and the threat it poses to our national broadband goals.

So what can we do to make the video market work more like an actual free market, one where consumers are sovereign and innovation is unshackled from an anachronistic and rigid market structure?

We already know the answer.

It's the same one that prompted Congress to overhaul our nation's communications laws in 1996, and it's the same one that's driving what little disruption we're currently seeing in the video market.

The answer is big open pipes.

- The entire point of the 1996 Telecommunications Act was the creation of robust and open telecommunications platforms that could deliver competitive voice, video and data services. Congress operated on the theory that having more open telecommunications platforms (be they copper, coax, fiber, terrestrial wireless or satellite) would enable more competition in the markets for the services delivered over those platforms.
- We have this wonderful thing called the Internet. It's a platform that comes into nearly everyone's home via the traditional public switched telecommunications network or the coaxial wires the cable system uses. And if the Internet remains an open and nondiscriminatory platform, like it has always been, then anyone can be a video distributor — not just the satellite, cable and telecom incumbents.
- But thanks to the FCC's irresponsible decisions on its authority over broadband communication networks, there is no guarantee that the Internet will remain a viable delivery platform for new video distributors. When the owners of the physical infrastructure, like a cable or telco network, can prevent anyone else from being a video distributor, that's a problem. When that same owner also owns the content that new video distributors need to compete, it's even worse.
- The least-regulatory free-market answer to the video market's problems is to throw money at it. If venture capitalists, in pursuit of a better video-bundling business model, invest in companies that throw money at the programmers, the programmers will embrace these alternative distribution platforms. Over time, this investment will produce new video business models where supply actually equals demand, giving consumers the surplus they've been denied for so long.
- But this investment and innovation will not happen if there is any uncertainty about the openness of the Internet delivery platform. When broadband providers embrace data caps that serve no legitimate engineering or economic function, they send a signal to the market that scarcity, not abundance, is the best business model. Artificial scarcity is a market failure, one that depresses investment and deprives Americans of the benefits of technological progress.

So the most obvious answer to this complex problem is the same one we came up with so long ago. We need public policy to allow innovation to happen.

If we keep the pipes open, the content will flow and consumers will win.

The unfortunate reality is that while the law of the land already contains policies designed to bring consumers robust, open networks, the FCC administratively repealed these policies. By giving the owners of the Internet's on-ramps the same deregulatory treatment under the law as the owners of the websites and applications that rely on those on-ramps to reach consumers, the FCC robbed Americans of both a competitive broadband market and a competitive video market.

Congress framed the 1996 Act as deregulation in exchange for competition. It may be time to reconsider this approach. If cable and telco transmission were affirmatively placed back under Title II (where Congress already put it), there might not be any need for much of the Title VI laws that govern multichannel distributors.

Big open pipes are the key to a truly competitive video market, as they will be the platform for a better video-distribution model. However, policymakers can't simply abandon consumers in this broken market while we wait for new online distribution models to emerge. We also need policies that would correct existing market failures and make the video market work better for consumers today. We also need to change the incentives for programmers to make it easier for them to step out of their comfortable cabal with the traditional multichannel distributors.

In the pages that follow, we discuss several policies such as a la carte pricing, wholesale unbundling, program access, transparency in rates, and improved video-navigation devices, which together in combination with robust open broadband networks will finally give consumers the video choices they demand.

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INTRODUCTION

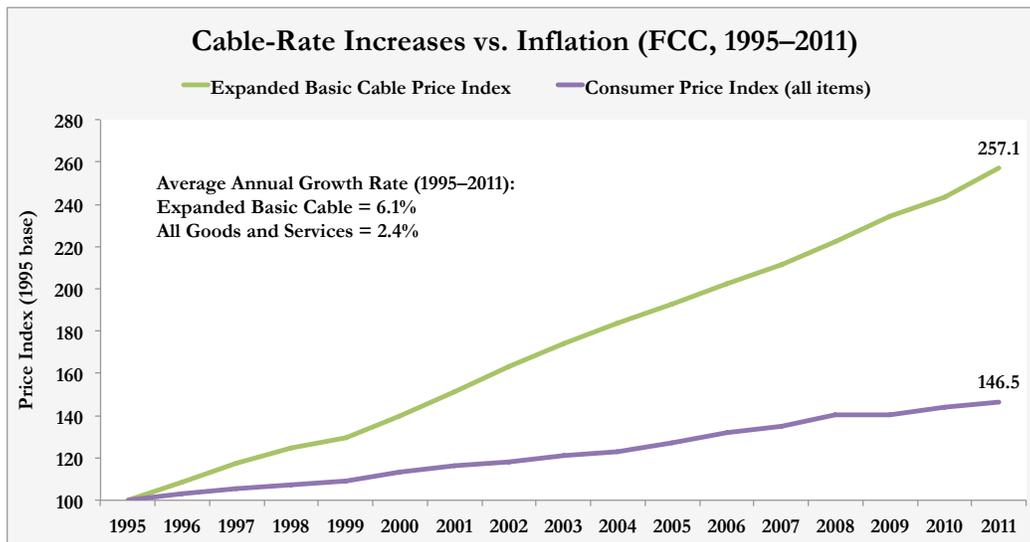
When Congress enacted the Cable Television Consumer Protection and Competition Act (“1992 Act”) it was responding to public outcry over ever-skyrocketing cable TV bills, which had become commonplace since Congress deregulated the cable industry in 1984.

The 1992 Act’s findings noted that the “average monthly cable rate has increased almost three times as much as the Consumer Price Index since rate deregulation.”¹ Rep. Ed Markey, lead sponsor of the House’s version of the legislation, characterized it as a “pro-consumer, pro-competition bill designed to rein in the renegades in the cable industry who are gouging consumers with repeated rate increases.”² Mr. Markey said the law would give consumers “the power to choose the cable services they want and to pay no more than they have to.”

Well, things did not go as planned.

In 1996, Congress relaxed the 1992 Act’s cable-rate regulation provisions (and the 1992 Act’s standards for determining effective competition were flawed to begin with, as we discuss below). The results of this monopoly deregulation were completely predictable. Congress weakened the provisions in the 1992 Act that were designed to address how monthly cable bills were increasing at nearly three times the rate of inflation, and since then cable bills have continued to increase at this same rate (see Figure 1).

Figure 1:



Sources: FCC, Free Press Research. Expanded basic cable price index includes services offered by wired cable, satellite, and some telco TV distributors.

This trend is only getting worse. Since the 2008 recession, the average annual rate of inflation was 1.4 percent, while the price of expanded basic cable service increased by an annual average of 5 percent.

Even more alarming, the limited amount of video competition the 1992 Act helped foster is doing nothing to discipline prices. A recent FCC study revealed that in communities deemed “subject to effective competition” (as

¹ Cable Television Consumer Protection and Competition Act of 1992, P.L. 102-385.

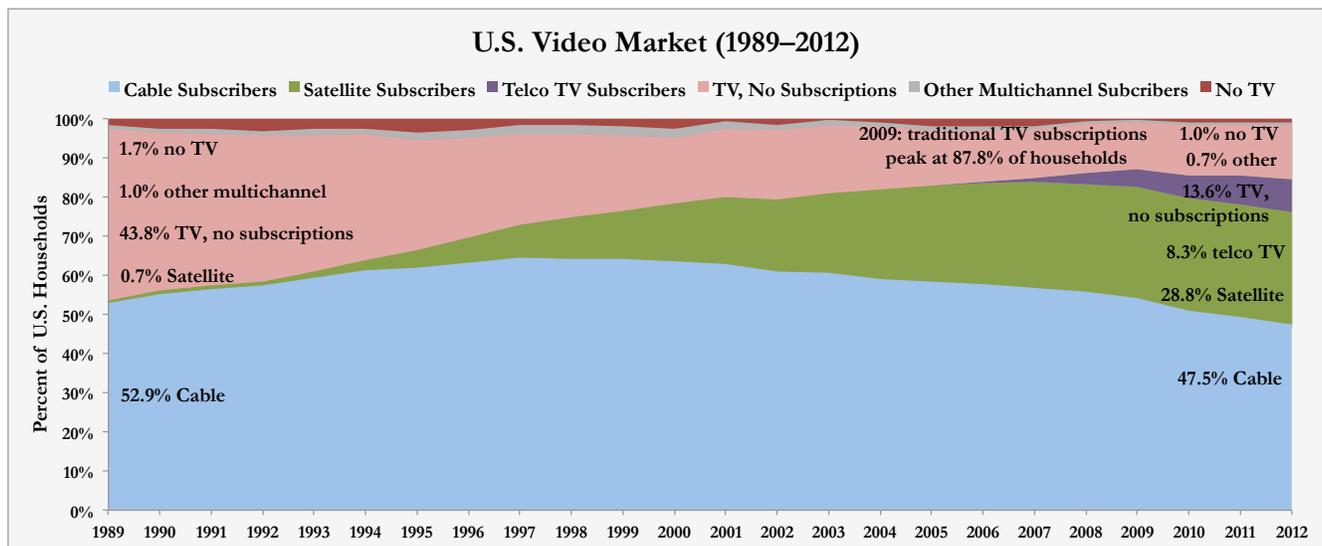
² “House Gets Cable TV Bill,” *Reuters*, March 26, 1992.

determined by the 1992 Act’s metrics), cable prices are actually three percent *higher* than prices in communities that don’t pass the 1992 Act’s effective competition test.³

Cable providers try to make us feel better about these rising bills by telling us how many more channels we have at our disposal (regardless of whether or not we actually watch them).⁴ And historically, most Americans complained about these annual price hikes but kept taking service. Despite the soaring prices, the percentage of U.S. households subscribing to a multichannel video service increased from 60 percent in 1992 to just over 85 percent today.

But we’ve apparently reached our breaking point. In 2009, the penetration of traditional TV subscription services peaked at 87.8 percent of households, and it has declined slightly every year since (see Figure 2).

Figure 2:



Sources: SNL Kagan, Free Press Research

Some of this decline may be a temporary result of the 2008–2009 economic recession and the subsequent slow recovery. Yet there is a small but growing number of Americans who consume just as much video content as their neighbors, but don’t get that content from traditional subscription services. Just over 5 percent of U.S. households have one or more televisions and subscribe to high-speed Internet service, but do not subscribe to a traditional pay-TV service like cable, satellite or telco video.⁵

These “cord cutters” are the subject of much media attention, and they are an obvious source of concern for many a cable company executive — though most execs rarely admit this.⁶ But beyond its implications for traditional pay-TV services, cord cutting is a sign of broader consumer frustration with the video market and the non-options that we’re given.

³See *Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992; Statistical Report on Average Rates for Basic Service, Cable Programming Service and Equipment*, Report, 27 FCC Red 9326, 9333 (2012) at Table 2 (*FCC 2012 Cable Price Survey*).

⁴See, e.g., William Triplett, “NCTA Challenges FCC Report: McSlarrow Maintains That Cable Prices Have Actually Gone Down,” *Variety*, Jan. 4, 2007 (quoting the cable industry’s then-top lobbyist stating that “the data clearly show that the real price per channel over 10 years has gone down, not up.”).

⁵Nielsen estimates that about 45 percent of the households that watch television over-the-air but do not subscribe to a multichannel video service do subscribe to a broadband service. See “Free to Move Between Screens: The Cross-Platform Report,” Nielsen Media Research, March 2013.

⁶See Karl Bode, “Nielsen Almost, Sort of Acknowledges Cord Cutting,” *DSL Reports*, March 14, 2013.

The video market is broken. Market failures are numerous. Facing little competition, programmers and distributors alike possess and exercise market power. Contractual obligations between them restrain trade and erect artificial barriers to entry for any new distributors. Both sides tie popular channels to unpopular channels. Principal-agent problems ensure that consumers have little sovereignty. Cross-subsidies distort prices in adjacent markets. And hidden prices obscure consumer price sensitivity, and ensure that efficient market equilibrium is never reached.

Consumers are willing to pay a fair price for content, but they are not happy with the bloated options the cable distributor/programmer cabal offers. New over-the-top distributors are eager to enter the market, but many find it difficult to obtain programming at a fair price, or at all. The millions of consumers who have opted out of the traditional multichannel market are a motivated and technically sophisticated bunch, but their numbers will remain small if nothing is done about the larger video market's many failures.

This paper examines the multichannel video industry's market structure and how it has evolved since the passage of the 1992 Act. Drawing on this analysis, we propose several areas of focus for policymakers interested in helping consumers by removing barriers to real competition and innovation in the video market. We also highlight how the video market's market failures are spilling over into the Internet access market, threatening our national goals for universal, affordable broadband communications infrastructure.

But ultimately, consumers don't care about market structure, or the nuts and bolts of the public policies that govern (or should govern) the multichannel market. Consumers just want to know why their cable bills continue to rise and whether or not Congress intends to do anything about it. As we discuss below, there is plenty of blame to go around — but little sign yet that policymakers are interested in bringing relief to rate-increase-weary consumers. That has to change, and it can if policymakers focus on the solutions we propose.

PART I: THE ECONOMICS OF THE MULTICHANNEL MARKET

The Multichannel Distributors: Happy, Profitable Middlemen

While many other sectors of the economy struggled during the recent recession, the multichannel video distribution industry⁷ showed great resilience. From 2007–2011, multichannel distributors' video revenues increased by 27 percent⁸ as the price of expanded basic cable service increased by 22 percent.⁹ This performance is impressive considering that during this period there was almost no growth in the total number of multichannel video subscribers.¹⁰

But the multichannel distributors are just that — distributors of someone else's programming. As the owners of that programming raise their licensing fees, distributors either have to pass those higher costs along to their subscribers

⁷ In this paper, the term "multichannel distributor" refers to traditional wired cable service providers (e.g., Comcast, Charter, Cox), Direct Broadcast Satellite service providers (DirecTV, DISH) and telco TV service providers (e.g., Verizon FiOS TV, AT&T U-Verse TV).

⁸ Data derived from various SNL Kagan reports. Total cable TV, telco TV and DBS video-segment revenues increased from \$77 billion in 2007 to \$97 billion in 2011.

⁹ See *FCC 2012 Cable Price Survey*. This data "includes operators of traditional coaxial and fiber wireline cable systems, municipalities, and telephone companies, including Verizon FiOS. It does not include MVPD operators of wireless systems, direct broadcast satellite (DBS), or AT&T U-Verse, because these operators are not associated with any FCC Community Unit Identifiers (CUID)."

¹⁰ See "U.S. Multichannel Industry Benchmarks," *SNL Kagan*, last accessed April 2013 (*SNL Kagan U.S. Multichannel Industry Benchmarks*). Total multichannel subscriptions increased from 97.7 million at the end of 2007 to 101 million at the end of 2011. Though the total number of subscriptions increased, the overall multichannel penetration during this period decreased from 87.8 percent to 85.4 percent of U.S. households.

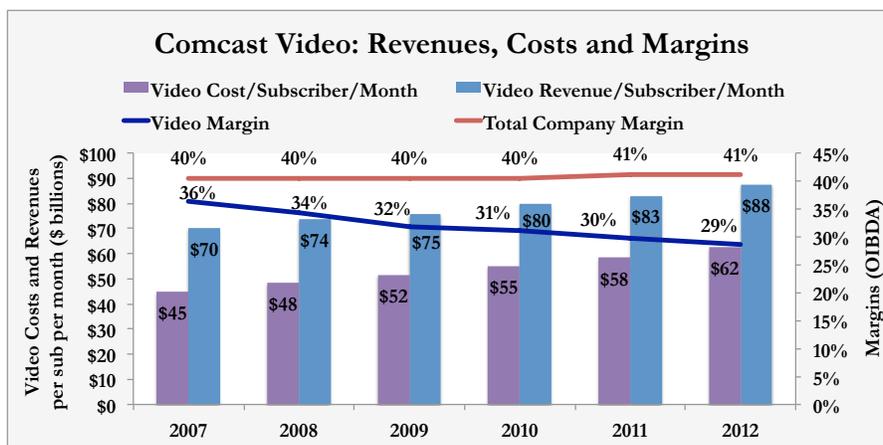
or accept lower profits on video. And for many years, the distributors simply passed along all of these increased programming costs.

In recent years, as local broadcasters have joined cable programmers in efforts to extract as much revenue as possible from multichannel distributors, the distributors have been forced to absorb at least a portion of these increased programming costs. Consider three of the nation’s largest cable TV distributors: Comcast, Time Warner Cable and Charter. From 2008–2012, programming costs for these three companies increased by a combined \$3.1 billion while video revenues increased by \$1.6 billion.¹¹ The results were similar for the Direct Broadcast Satellite (“DBS”) multichannel distributors. From 2008–2012, their programming costs increased 26 percent while video revenues increased 23 percent.¹²

There is a key difference, however, between the wired multichannel distributors and the DBS providers. Wired providers like Comcast, Time Warner Cable and Charter can use their high-speed Internet business (which is subject to very little competition) to offset declining video profits and maintain growth in their overall profits. DBS providers are almost completely reliant on their video-segment performance. Thus, if they wish to maintain a stable profit margin, they must pass along more of the programming-cost increases to their customers.

A comparison of the video and total company operating profit margins for Comcast, Time Warner Cable and Charter in recent years illustrates just how crucial the high-speed Internet segment is to these companies. From 2007–2012, Comcast’s monthly video costs per subscriber increased from \$45 to \$62 while monthly revenues increased from \$70 per subscriber in 2007 to \$88 in 2012. This equates to a decline in the video-operating margin from 36 percent to 29 percent. But Comcast’s total company operating margin rose slightly from 40 percent to 41 percent (see Figure 3).¹³

Figure 3:



Source: SNL Kagan

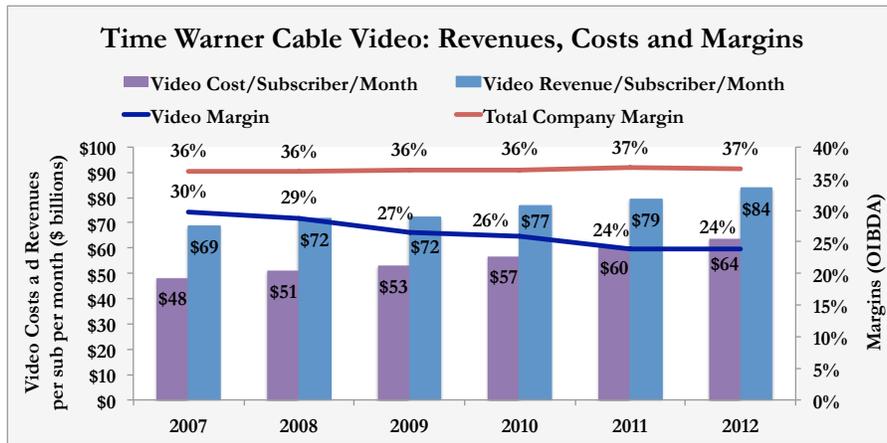
Time Warner Cable’s results mirror Comcast’s during this period. The company’s video-operating margin declined from 30 percent in 2007 to 24 percent in 2012. This decline, however, was offset by high-speed data earnings, which led to Time Warner Cable’s total company operating margin increasing from 36 percent in 2007 to 37 percent at the end of 2012 (see Figure 4).

¹¹ Tony Lenoir, “Programming Expenses up 27% Since 2008; to Grow at 7% CAGR in Next Six Years,” *SNL Kagan*, April 15, 2013.

¹² Information obtained from DISH and DirecTV’s annual 10-K SEC filings.

¹³ See “Cable MSO Margin Analysis by Product — Historical Benchmark,” *SNL Kagan*, March 26, 2013. Margins are Operating Income Before Depreciation and Amortization (OIBDA) margins.

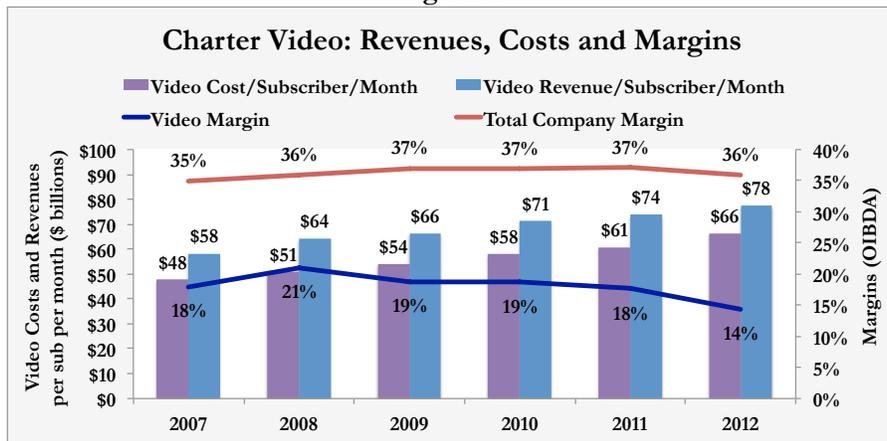
Figure 4:



Source: SNL Kagan

Charter, the nation’s fourth-largest wired cable provider, saw a similar decline in video-operating margins but a stable overall company operating margin. Charter’s total company margin rose from 35 percent in 2007 to 36 percent in 2012. The company’s video-operating margin declined from 18 percent in 2007 to 14 percent in 2012 (see Figure 5).

Figure 5:



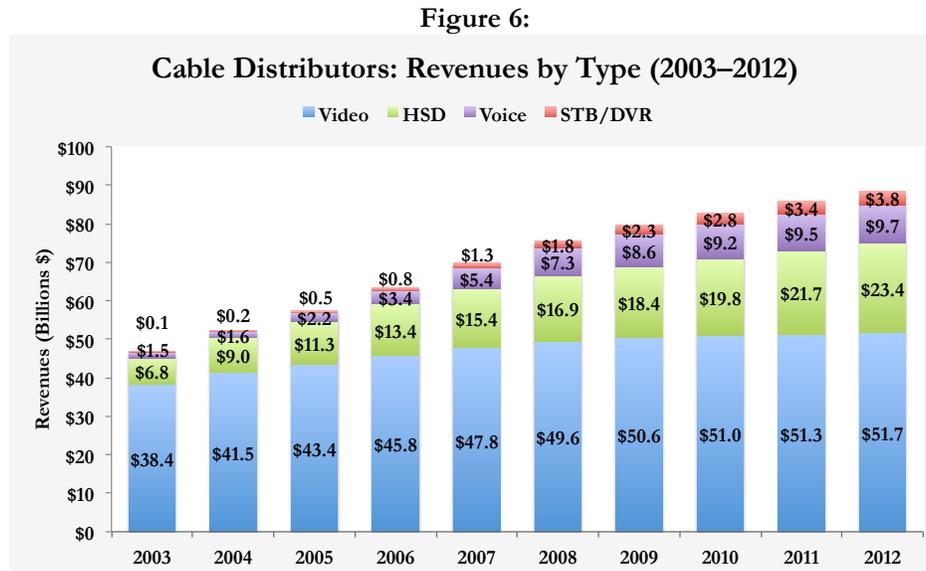
Source: SNL Kagan

All multichannel distributors are feeling margin pressures from rising programming costs. But because the wired providers bundle video with data and voice, they are able to spread the programming-cost increases across the different services in the bundle. Put another way, wired providers are able to use broadband — a service consumers increasingly view as a must-have utility, one offered in a market with very little competition — to cross-subsidize their declining video profits.

Because consumers are less sensitive to increases in the price of the bundle versus the price of video alone, this cross-subsidy allows the wired providers to maintain stable company-wide margins, as we see in the figures above. However, smaller Multiple System Operators (“MSOs”) of wired cable and telco video service do not have the scale to obtain the volume-programming discounts larger distributors like Comcast enjoy (such distributors typically negotiate volume-programming discounts as high as 30 percent off the standard rate smaller providers like Charter

pay).¹⁴ These smaller distributors are feeling the most pressure on video margins from programming-cost increases, and some are even contemplating exiting the video business altogether, or partnering with over-the-top video providers in lieu of purchasing licensing rights from cable programmers.¹⁵

Even though the traditional cable TV providers are experiencing declining video margins, the bulk of their revenues still come from the video segment. However, high-speed data, with its low operating costs, is quickly becoming a substantial generator of free cash flow for the cable companies. In 2003, cable distributors brought in \$38 billion from video, accounting for 82 percent of all the industry’s revenues. Ten years later, video revenues had increased to \$52 billion, but the segment’s total share of industry revenues declined to 59 percent due to the substantial increase in data, voice and set-top box fees (see Figure 6).¹⁶



Source: SNL Kagan

Broadband’s importance to wired cable companies like Comcast and Time Warner Cable is heightened by the fact that these and other traditional cable providers have experienced a slow but steady decline in the number of video subscribers in the past decade. This decline, which accelerated in 2008, is largely due to cable subscribers switching to AT&T’s or Verizon’s bundled video/data/voice offerings.

From 2008–2012, traditional cable TV providers *lost* 7.3 million video subscribers, while telco TV and satellite TV providers added 6.8 million and 2.9 million video subscribers respectively. However, the traditional cable companies aren’t losing too much sleep over this trend, as they’ve been able to more than offset the decline in video subscribers with a rise in high-speed data customers (see Figure 7).

Though telco TV is threatening cable’s dominance in some markets, AT&T’s U-Verse and Verizon’s FiOS TV deployments remain geographically limited, available to approximately one-third of U.S. households.¹⁷ This fact,

¹⁴See Joe Flint, “Cox Cable Wants FCC to Regulate Programming Deals,” *Los Angeles Times*, Sept. 25, 2012. See also Tony Lenoir, “Factoring in Programming Fee Volume Discounts in Top Cable MSOs’ Video Margins,” *SNL Kagan*, Oct. 3, 2012.

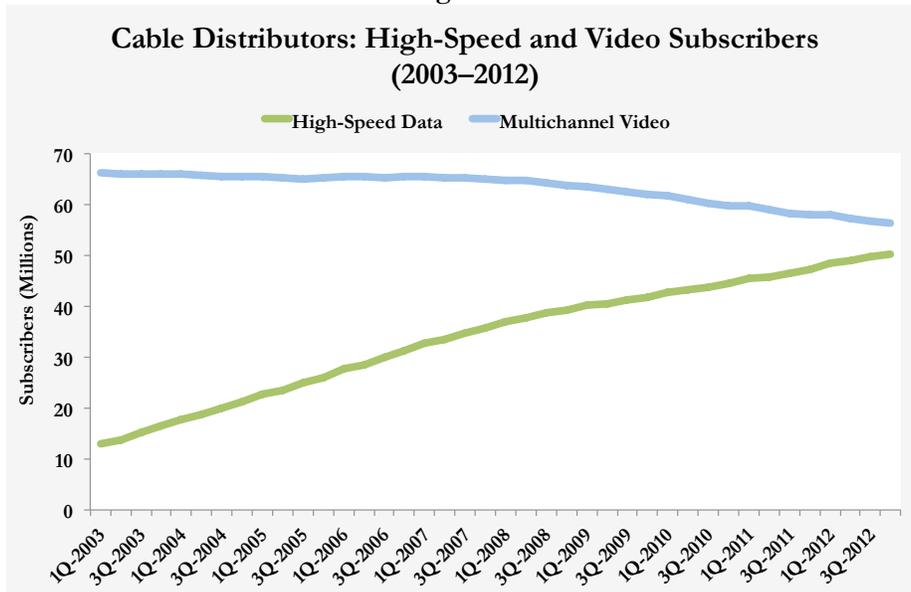
¹⁵See “ACA’s Polka: Small Cable Operators May Exit Pay TV Business,” *Fierce Cable*, March 13, 2013.

¹⁶ Figures are for the traditional wired cable-distribution industry and do not include telco or satellite providers. See *SNL Kagan U.S. Multichannel Industry Benchmarks*.

¹⁷ Verizon FiOS multichannel subscription services are available in 14.2 million U.S. homes (Verizon Communications Inc., SEC Form 10-K, Dec. 31, 2012). AT&T U-Verse multichannel subscription services are available in 24.5 million U.S. homes (AT&T Inc., SEC Form 10-K, Dec. 31, 2012).

combined with the superior speeds cable modem offers versus those found in traditional DSL Internet access service, allowed cable to take 88 percent of new broadband additions in 2012.¹⁸ And because broadband is much more profitable than video (high-speed data OIBDA margins are two to four times higher than video margins), cable’s fiscal prospects are as good as they’ve ever been, even in today’s stagnant economy.¹⁹

Figure 7:



Source: SNL Kagan

The wired distributors’ ability to grow their businesses in the face of rising programming costs and declining video subscribership is a testament to the strength of the bundled service business model and the market power that these providers enjoy, particularly in the provision of broadband. Cable-telco duopolists like Comcast and Verizon use the bundle to ensure that the rates customers pay for each underlying service are hidden; that churn is low; that average revenue per user (“ARPU”) is steadily increasing; and that subscriber counts are stable.

A decade ago, subscription TV was the sticky service in the cable bundle that helped sell broadband and phone services. But now providers are tying television service (and to a lesser extent, phone service) to high-demand broadband product. Indeed, some providers, like Comcast and Verizon, actually sell the TV-broadband bundle for less than stand-alone broadband.²⁰ Other providers price TV-broadband bundles only marginally higher than stand-alone broadband.²¹

¹⁸See “2.7 Million Added Broadband from Top Cable and Telephone Companies in 2012,” Leichtman Research Group, March 19, 2013. The release notes that “AT&T and Verizon added 3.08 million fiber subscribers (via U-Verse and FiOS) in 2012, while having a net loss of 3 million DSL subscribers.”

¹⁹See Tony Lenoir, “Cable MSOs Log Largest Top-Line Gains in Five Years in 2012,” *SNL Kagan*, March 15, 2013. The article notes that SNL Kagan anticipates that “video will continue to face headwinds, including sub erosion and increasing programming expenses. So far, the industry has been able to pass most of the rising costs on to the consumer. But this strategy is not viable in the long run in a world of high unemployment, stagnating income, low housing formation and burgeoning over-the-top (OTT) alternatives. That said, cash flows grew at virtually the same pace as revenues in 2012, due essentially to rate hikes in HSD and the industry’s growing success in nontraditional, high-margin revenue streams such as advertising, up 15% to a record \$4 billion for the top six operators, and the ‘other’ category, which grew 26% in 2012 to reach \$6.39 billion, contributing 12% to the overall annual gains.”

²⁰ As of March 2013, the stand-alone non-promotional price for Comcast’s 30Mbps high-speed Internet service in Denver was \$74.95 per month. If the customer bundles basic video with that same 30Mbps, the non-promotional price declines to \$64.99 per month. Verizon customers in Northern Virginia can purchase stand-alone 15Mbps FiOS high-speed Internet service

These companies characterize these pricing schemes, which in some cases mean lower bills for consumers who take video services that they may not even want, as value offers.²² But the underlying economics indicate that providers are using broadband — a highly profitable utility communications service subject to very little competition — to cross-subsidize video and keep total revenue and subscribership numbers high.

It's illegal for telecommunications carriers to “use services that are not competitive to subsidize services that are subject to competition.”²³ Lawmakers took this step in part because of the standard concerns about market power abuses distorting competition, producing economic inefficiency and depleting consumer surplus. But Congress also singled out this kind of cross-subsidization based on the well-understood regulatory economic principle that “[i]n general, joint and common costs should be allocated based on the demand each service places on the network.”²⁴

Cable companies have thrown this principle out the window, devoting approximately 5 percent of their network capacity to broadband, with most of the remainder devoted to linear and on-demand video.²⁵ Yet despite consuming just 3 percent of the cable system's capacity, high-speed data services account for more than a fourth of the cable industry's revenues, a share that is rapidly increasing (see Figure 7 above).

Now it's true that the FCC treats facilities-based broadband providers as pure information service providers and not telecom carriers — even though these companies offer a service that allows users to transmit information of their choosing between points the user specifies.²⁶ But if the Commission had not made this colossal classification mistake (which contradicted Congress' express intent),²⁷ the industry's practice of cross-subsidizing video services with profits generated from broadband would draw policymakers' scrutiny.

for \$74.99 per month (the non-promotional rate). If the customer bundles that with video, the non-promotional rate declines to \$69.99 per month.

²¹ For example, in the suburbs of New York City, Time Warner Cable sells stand-alone high-speed Internet service for a non-promotional monthly price of \$54.99. Adding video increases the monthly price by only \$10.

²² See, e.g., “Verizon Combines Insane Internet Speeds With Sensible Value in New FiOS Bundles,” Verizon press release, June 18, 2012.

²³ 47 U.S.C. § 254(k).

²⁴ See “Report of the Committee on Commerce, Science, and Transportation on S.652, Telecommunications Competition and Deregulation Act of 1995,” S. Rpt. 104-23, March 30, 1995 (*Senate Committee Report*), at 30.

²⁵ A typical wired coaxial cable system has a capacity of 125 analog “channels” of six megahertz each, and only four of these 125 channels are utilized for high-speed Internet service (today's digital compression technology now makes it possible for more than a dozen digital “channels” to be offered in the same amount of space an analog channel occupies). See Peter Ha, “The Best Cable Modem Is the Motorola SB6141,” *The Wirecutter*, Jan. 6, 2013 (citing quotes from Comcast reflecting its use of four DOCSIS channels for broadband. Cox and TimeWarner Cable are reportedly planning to utilize up to eight channels in the future).

²⁶ See 47 U.S.C. § 153(50) (“The term ‘telecommunications’ means the transmission, between or among points specified by the user, of information of the user's choosing, without change in the form or content of the information as sent and received.”); 47 U.S.C. § 153(53) (“The term ‘telecommunications service’ means the offering of telecommunications for a fee directly to the public, or to such classes of users as to be effectively available directly to the public, regardless of the facilities used.”); 47 U.S.C. § 153(24) (“The term ‘information service’ means the offering of a capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing, or making available information via telecommunications, and includes electronic publishing, but does not include any use of any such capability for the management, control, or operation of a telecommunications system or the management of a telecommunications service.”).

²⁷ See *Senate Committee Report* at 18 (“‘Telecommunications service’ does not include information services, cable services, or ‘wireless’ cable services, but does include the transmission, without change in the form or content, of such services.” [emphasis added]); see also *id.* at 27 (“As defined under the 1934 Act [as amended by this bill], ‘telecommunications services’ includes the transport of information or cable services, but not the offering of those services. This means that information or cable services are not included in the definition of universal service; what is included is that level of telecommunications services that the FCC determines should be provided at an affordable rate to allow all Americans access to information, cable, and advanced telecommunications services that are an increasing part of daily life in modern America” [emphasis added]).

As these data indicate, and as we discuss further below, the video market’s failures are spilling over into the broadband market. This spillover threatens our national policy goals of creating affordable, universally available and maximally utilized broadband communications infrastructure.²⁸

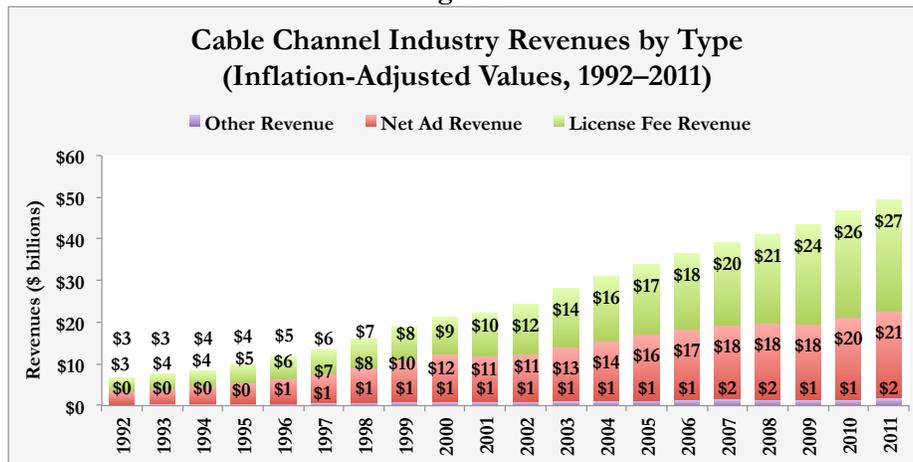
This is not some trivial trend in the tech market. Broadband is now an indispensable utility for most Americans and is a major part of our national economy. The phone and cable companies have long used this critical infrastructure to earn economic rents that are not competed away in their duopoly. Now Americans are being asked to pay still more for broadband service when its price should be dropping. This is happening all in the service of sending increasingly hefty checks to cable channels that pocket a healthy profit before sending that money along to programming conglomerates and monopoly sports leagues.

The Programmers: Making You Pay More for More of What You Don’t Want

As impressive as the multichannel distributors’ fiscal performance was through the recent economic downturn, it pales in comparison to the growth the cable programmers enjoyed. From 2007–2011, total cable programmer revenues grew at a compound annual growth rate (“CAGR”) of 8 percent, a result SNL Kagan characterized as “pretty impressive given the brutal recession that we were in during this period.”²⁹

This recent growth, driven by increased licensing fees, is just a continuation of an impressive rise that began to gain momentum more than a decade ago. At the turn of the 20th century, advertising comprised 55 percent of the cable programming industry’s revenues. Today the licensing fees multichannel distributors pay make up the bulk of the programmers’ revenues (see Figure 8).

Figure 8:



Sources: SNL Kagan, Free Press Research

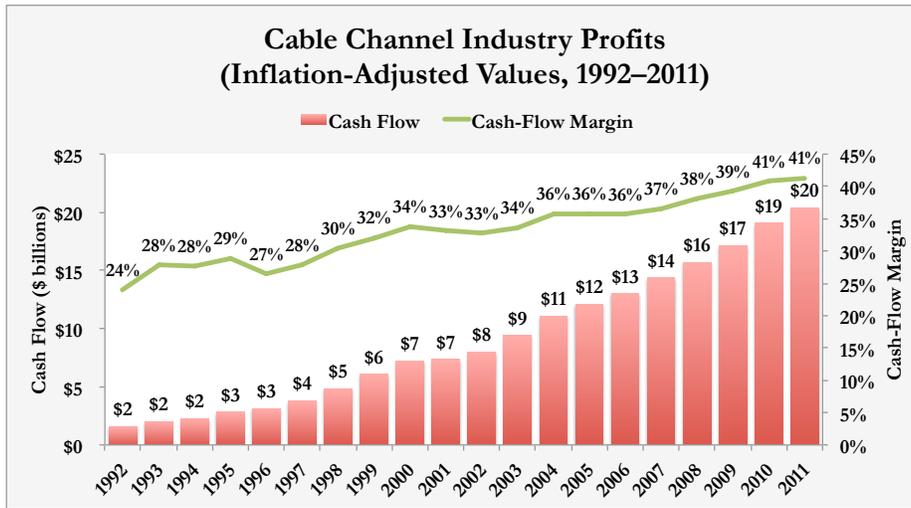
The increased revenues have translated into increased profits. Twenty years ago, total programmer profits (expressed as cash flows) were \$2 billion (inflation-adjusted, 2011-dollar value), representing a margin of 24 percent. Profits have increased 10-fold to \$20 billion today, with margins rising to an impressive 41 percent (see Figure 9).

It’s true that the cable programmers’ cost of doing business has increased dramatically over the past two decades. Sports channels are forking over record amounts of cash to secure broadcasting rights from sports leagues, and basic cable channels like AMC and FX now produce high-quality original programming in addition to running their usual syndicated fare.

²⁸ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009); see also Section 706 of the Telecommunications Act of 1996, Pub. L. 104-104, 110 Stat. 56 (1996) (“1996 Act”), 47 U.S.C. § 1302.

²⁹ Derek Baine, “Cable Networks Posting Strong Numbers Despite Tepid Economy,” *SNL Kagan*, Aug. 1, 2012.

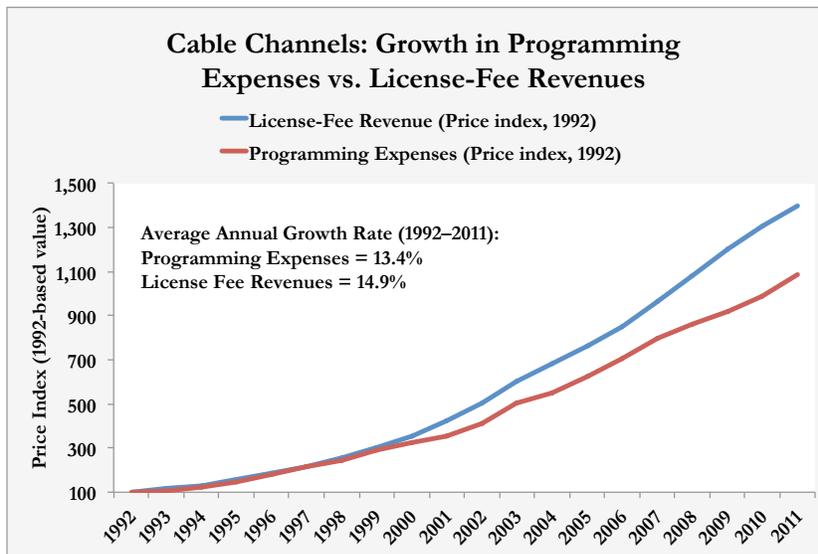
Figure 9:



Sources: SNL Kagan, Free Press Research

But as the margin data above suggest, the increased revenues brought in from advertising and the licensing fees cable subscribers pay more than cover programmers’ increased production costs. From 1992–2000, the licensing fees programmers earned increased at the same rate as their programming expenses. But since the turn of the century, the growth in programmers’ licensing fees has far exceeded the growth in their expenses to produce or obtain content. During the last two decades, the average annual growth rate for programming expenses was 13.4 percent, while licensing fees rose at an average annual rate of 14.9 percent (see Figure 10).

Figure 10:



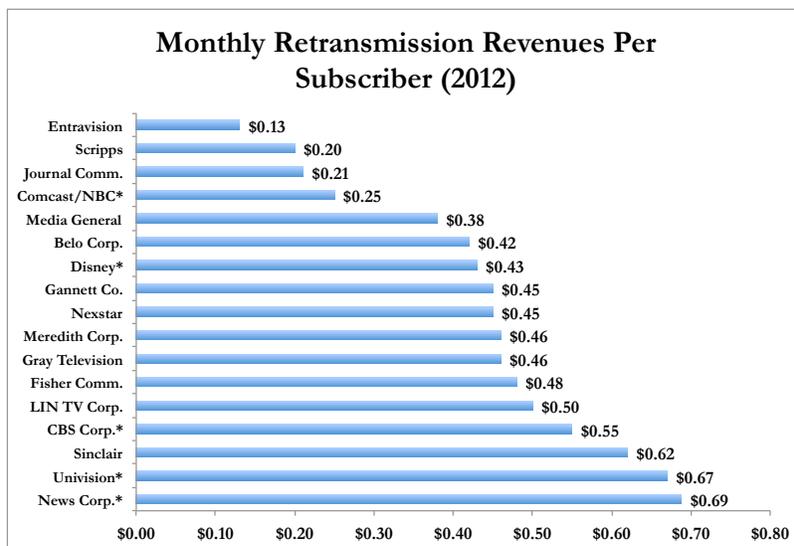
Sources: SNL Kagan, Free Press Research

Cable channels aren’t the only content providers willing to treat cable subscribers like ATMs. In recent years, broadcasters have made extensive use of the retransmission-consent rights Congress granted them. Payments from multichannel video distributors to local broadcasters reach record levels every fiscal quarter, in some cases despite declining ratings. On a recent earnings call, News Corp. President and COO Chase Carey told analysts “the reality of retransmission is it enables the broadcast business to be a healthy business. As I said ... we have had a very

disappointing year ratings-wise but our broadcast business is up [in] profitability and that’s because we are building it into a dual-revenue business.”³⁰

News Corp.’s owned-and-operated (“O&O”) FOX and MyNetworkTV stations are faring particularly well. These 29 stations, which reach 38 percent of U.S. households, brought in an average of \$0.69 per subscriber per month in 2012 (see Figure 11). This high rate partially reflects the popularity of FOX’s NFL programming, but is also an example of the advantages News Corp. enjoys when negotiating carriage of its cable channels simultaneously with its broadcast channels.³¹

Figure 11:



Source: SNL Kagan. * Owned and operated broadcast network stations

The broadcast industry as a whole has seen retransmission revenues increase more than 10-fold in just the past six years, from \$215 million in 2006 to \$2.4 billion in 2012. In 2006, retransmission revenues comprised just 1 percent of broadcast revenues. That figure has grown to 9 percent today, and shows no sign of slowing (see Figure 12).

These data are for the broadcast industry as a whole, but the largest publicly traded broadcast companies are outperforming the sector average. In 2012, retransmission revenues comprised 19 percent of News Corp.’s broadcasting revenues, up from 11 percent just two years earlier.³²

Retransmission, along with political advertising, is rapidly becoming a critical source of growth for a sector that continues to lose viewers.³³ Fall 2012 was particularly brutal for the major networks (arguably excluding NBC, which saw 11 percent audience growth in the coveted 18–49 demographic, though much of that “growth” was recovery from NBC’s dismal performance in 2011). ABC’s viewership was down 19 percent, FOX’s down 24 percent and CBS’ down 25 percent. Yet the networks’ O&O stations all enjoyed substantially higher retransmission fees, illustrating the complete disconnect between supply and demand that is a hallmark of the broken multichannel video market.

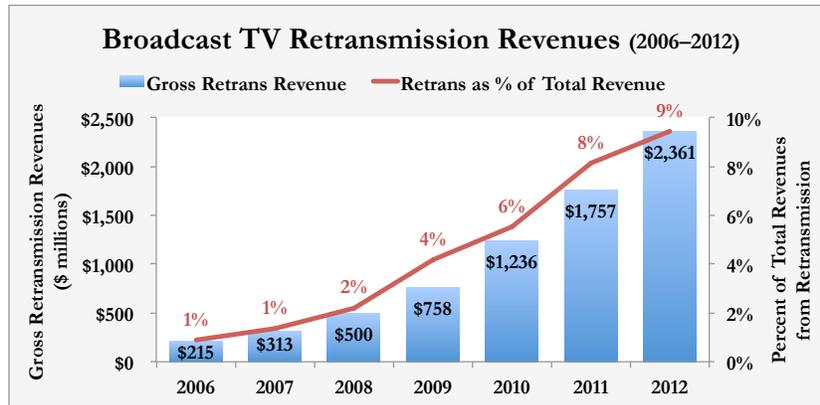
³⁰See News Corp. Q2 2013 Earnings Call, Feb. 6, 2013. News Corp.’s 29 broadcast stations brought in \$308 million in retransmission revenues in 2012, the second-highest amount of any broadcast station group.

³¹See, e.g., Brian Stelter, “Time Warner and Fox Extend Talks Overnight,” *New York Times*, Dec. 31, 2009.

³²See Justin Nielson, “TV Retrans up 34% in Q4’12,” *SNL Kagan*, March 27, 2013.

³³See Christopher S. Stewart and John Jannarone, “Viewership Drops for Fall TV Season,” *Wall Street Journal*, Oct. 11, 2012 (“The major broadcast networks lost an average of 15% of their viewers in the 18–49 demographic compared with the first two weeks of last season. In that same group, viewership of ad-supported cable channels dropped 1%, according to Nielsen”).

Figure 12:



Source: SNL Kagan

Indeed, the broadcasters aren't the only programmers increasing their intake of fees (and profits) in spite of declining viewership. Nine of the 25 most-watched cable channels experienced a decline in primetime viewership over the last decade, yet all increased the per-subscriber licensing fees they receive. Six of these nine channels enjoyed higher operating profit margins despite losing audience share (see Figure 13). Consider Lifetime Network, which lost nearly two-thirds of its primetime audience share over the last decade. Despite this decline, Lifetime's operating profit margin remained largely unchanged, due in part to a doubling of its per-subscriber licensing fees.

It's clear that the cable programming business is a good one to be in, particularly for those programmers that can leverage their ownership of the higher-demanded channels to force multichannel distributors to purchase much less desired channels. Programmers and distributors have long viewed this practice of "wholesale bundling" as mutually beneficial. It enables both parties to grow revenues while offering the illusion of value through an ever-expanding channel lineup that cable subscribers are forced to buy.

There have recently been challenges to this model. In 2009, a group of cable and satellite subscribers jointly sued several distributors and programmers over the wholesale bundling practice. Three years later, the United States Court of Appeals for the Ninth Circuit ultimately decided against the subscribers.³⁴ The Court ruled that though wholesale bundling may represent a form of product tying, the plaintiffs failed to demonstrate that the practice harmed competition in the market for the tied channels, even if it did harm the subscribers themselves. In that case, programmers like NBCU, Disney, News Corp., and Viacom stood hand in hand with cable companies like Comcast, Time Warner Cable, Cox, and Cablevision to defend this form of product tying.

³⁴ *Brantley v. NBCUniversal, Inc.*, 675 F.3d 1192 (9th Cir. 2012).

**Figure 13:
Top Cable Channels: License Fees, Programming Costs, Profits and Viewership
(2002 vs. 2011)**

Basic Cable Network	License Fee Revenues Per Subscriber Per Month			Programming Costs (\$ millions)			Cash-Flow Margin			Change in Primetime Audience Share, 2002–2011
	2002	2011	Change (multiple)	2002	2011	Change (multiple)	2002	2011	% Change	
USA Network	\$0.39	\$0.60	1.5	\$364	\$731	2.0	44%	48%	8%	30%
ESPN	\$1.60	\$4.77	3.0	\$1,666	\$4,984	3.0	24%	29%	21%	26%
Disney Channel	\$0.73	\$0.94	1.3	\$141	\$291	2.1	56%	61%	9%	36%
TNT	\$0.71	\$1.13	1.6	\$599	\$1,112	1.9	39%	44%	14%	-15%
Nickelodeon	\$0.32	\$0.51	1.6	\$176	\$390	2.2	59%	63%	7%	-22%
FOX News	\$0.17	\$0.79	4.6	\$127	\$542	4.3	29%	55%	88%	17%
History	\$0.14	\$0.24	1.7	\$132	\$282	2.1	31%	43%	41%	54%
Syfy	\$0.13	\$0.23	1.8	\$132	\$264	2.0	46%	47%	4%	18%
TBS	\$0.26	\$0.54	2.1	\$338	\$576	1.7	39%	47%	22%	-31%
A&E	\$0.18	\$0.27	1.5	\$198	\$377	1.9	41%	36%	-12%	0%
FX Network	\$0.27	\$0.45	1.7	\$217	\$426	2.0	31%	53%	69%	20%
ABC Family	\$0.17	\$0.23	1.4	\$137	\$259	1.9	38%	49%	29%	12%
HGTV	\$0.05	\$0.14	2.8	\$100	\$238	2.4	45%	57%	27%	27%
Discovery	\$0.23	\$0.34	1.5	\$108	\$215	2.0	60%	53%	-12%	-22%
Food Network	\$0.03	\$0.16	5.3	\$66	\$248	3.7	33%	60%	80%	41%
MTV	\$0.22	\$0.37	1.7	\$268	\$594	2.2	56%	46%	-16%	-15%
Lifetime	\$0.16	\$0.30	1.9	\$304	\$390	1.3	36%	35%	-3%	-63%
TLC	\$0.15	\$0.18	1.2	\$91	\$111	1.2	57%	59%	4%	-23%
AMC	\$0.21	\$0.24	1.1	\$80	\$168	2.1	48%	53%	10%	5%
truTV	\$0.08	\$0.11	1.4	\$111	\$255	2.3	-1%	22%	4560%	-4%
Comedy Central	\$0.08	\$0.16	2.0	\$141	\$276	2.0	23%	45%	91%	21%
TV Land	\$0.07	\$0.13	1.9	\$49	\$122	2.5	50%	52%	5%	-15%
Bravo	\$0.12	\$0.20	1.7	\$66	\$245	3.7	36%	50%	40%	102%
Hallmark	\$0.04	\$0.06	1.5	\$51	\$123	2.4	-85%	33%	138%	28%
MSNBC	\$0.13	\$0.17	1.3	\$139	\$200	1.4	-7%	47%	749%	51%

Source: SNL Kagan

But the cracks in the cabal model are starting to show.

Earlier this year, Cablevision filed suit against Viacom, alleging that the programmer’s practice of tying little-watched channels to popular networks violates several federal and state antitrust laws.³⁵ Cablevision argues that to carry Viacom’s popular “must-have” programming aimed at children, young adults, African-American audiences, and comedy audiences (offered, respectively, on Nickelodeon, MTV, BET, and Comedy Central), Cablevision must also purchase and place on its basic tier an entire suite of unpopular channels (including CMT, CMT Pure Country, LOGO, MTV Hits, MTV Jams, Nick Jr., Nick 2, Nicktoons, Palladia, TeenNick, Tr3s, VH1 Classic and VH1 Soul). Cablevision characterized VH1, TV Land, MTV2 and Spike TV as “core” channels, meaning they’re moderately popular but are not the marquee channels in their respective genera (see Figure 14).

³⁵ *Cablevision Sys. Corp. v. Viacom Int'l*, No. 13-cv-01278 (S.D.N.Y. Feb. 27, 2013).

**Figure 14:
Viacom Cable Networks: Must-Have, Core, and Suite Channels**

Network	License Fee Revenues Per Subscriber Per Month	Ratings Ranking (24 hour, 2011)
Nickelodeon	\$0.51	1
MTV	\$0.37	20
Comedy Central	\$0.16	23
BET	\$0.18	28
VH1	\$0.18	41
TV Land	\$0.13	18
MTV2	\$0.06	52
Spike TV	\$0.23	26
CMT	\$0.10	47
CMT Pure Country	\$0.05	Not Rated
LOGO	\$0.05	92
MTV Hits	\$0.02	Not Rated
MTV Jams	\$0.02	Not Rated
Nick Jr.	\$0.19	22
Nick 2	\$0.01	Not Rated
Nicktoons	\$0.07	46
Palladia	\$0.09	Not Rated
TeenNick	\$0.10	50
Tr3s	\$0.03	Not Rated
VH1 Classic	\$0.07	97
VH1 Soul	\$0.05	Not Rated

Sources: SNL Kagan, Cablevision

Using ratings data obtained from its own set-top boxes, Cablevision noted that from 2010–2012, many of the tied channels saw substantial ratings declines, including a 75 percent decline for VH1 Soul and a 72 percent decline for MTV Hits. Cablevision stated that to buy only the handful of Viacom channels it wanted to carry, it would have needed to pay \$1 billion *more* than the cost of simply taking the entire bundle. Taking more channels from Viacom actually cost less. And this additional fee alone is more than Cablevision’s entire programming budget.

Though forcing subscribers to pay for channels they will never watch is obviously anti-consumer, Cablevision’s legal case hinges on its ability to show harm to competition in the market for the non-marquee networks. The company has rightly pointed out that being forced to pay for and carry so many channels on its basic tier harms independent niche channels that Cablevision would otherwise carry if not for cost and capacity concerns.

It’s easy to see why large programmers like Viacom are so enamored of the wholesale bundling model. It allows them to repackage the same content and force all basic cable subscribers to pay for these networks. And because their licensing fees are not directly related to the size of each channel’s viewing audience, programmers can earn healthy profit margins simply by repackaging low-cost content and forcing distributors to carry these low-demand channels on the basic tier. In 2011, more than half of the 20 most profitable networks (measured by cash-flow margin) were not ranked among the 20 most-watched channels (see Figure 15).

**Figure 15:
Top 20 Most Profitable Cable Networks
(by margin, 2011)**

Network	Cash-Flow Margin (%)	License Fee Revenues Per Subscriber Per Month	Ratings Ranking (24 hour, 2011)	Owner
Nickelodeon	63.4	\$0.51	1	Viacom
Disney Channel	61.2	\$0.94	2	Disney
Food Network	59.8	\$0.16	14	Scripps
TLC	59.4	\$0.18	24	Discovery
Hallmark Movie Channel	59.1	\$0.02	57	Crown Media
CNBC	59.1	\$0.31	45	Comcast
VH1 Classic	58.4	\$0.07	97	Viacom
HGTV	57.4	\$0.14	12	Scripps
BET	55.6	\$0.18	28	Viacom
Destination America	55.3	\$0.07	72	Discovery
SOAPnet	54.7	\$0.16	51	Disney
FOX News	54.5	\$0.79	5	News Corp.
FX Network	52.7	\$0.45	11	News Corp.
AMC	52.6	\$0.24	15	AMC
Discovery	52.5	\$0.34	16	Discovery
TCM	52.4	\$0.28	Not Rated	Time Warner
TV Land	52.2	\$0.13	18	Viacom
Nick Jr.	52.0	\$0.19	22	Viacom
National Geographic	52.0	\$0.22	42	News Corp.
Nick 2	51.9	\$0.01	Not Rated	Viacom

Source: SNL Kagan

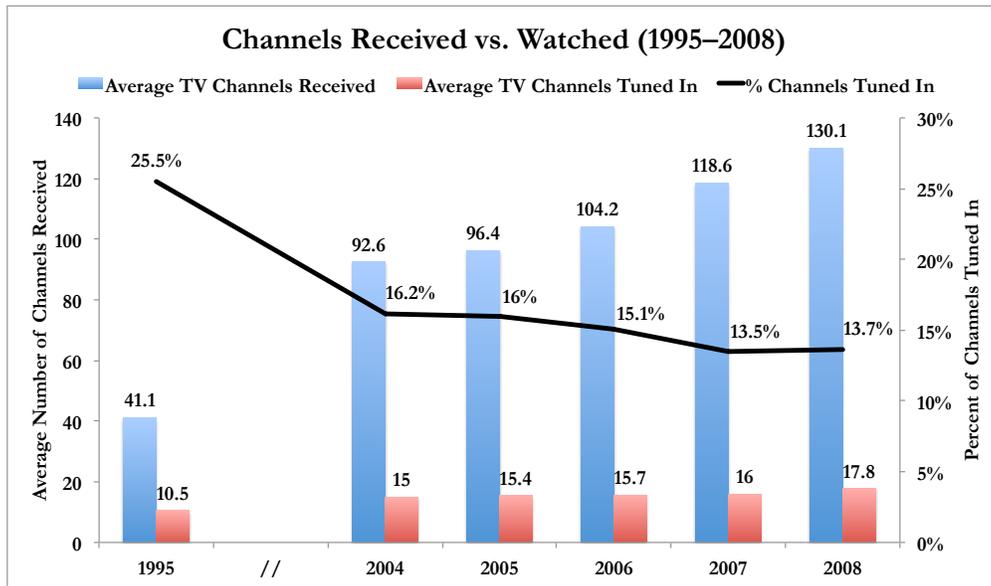
While the linear channel model may have served programmers, distributors, and even some consumers well in the past, it's now clear that the main beneficiaries are the largest programmers like Viacom and others, and the largest vertically integrated distributors like Comcast. The entire concept of a linear channel, primarily programmed with the same exact content found on numerous other linear channels or an online platform, is anachronistic and economically inefficient in today's emerging broadband market. Consumers are forced to pay numerous times for the same programming — programming that many of them will never watch.

500 Channels, Nothing to Watch — and No One Watching

In 1992, *Time* published an article about the then-upcoming deployment of digital cable, with the title “500 Channels and Nothing to Watch.”³⁶ Though the title was a joking reflection of a long-standing cultural complaint about the state of television, it proved prescient. But perhaps a more accurate description would be “500 channels on and no one watching.” Indeed, in 1995 the average multichannel subscription household received 41 channels, but tuned into only 11 of these stations. In 2008 (the last year Nielsen reported this data), the average multichannel household tuned into only 18 of the 130 channels received (see Figure 16).

³⁶ “500 Channels and Nothing to Watch,” *Time Magazine*, Dec. 14, 1992.

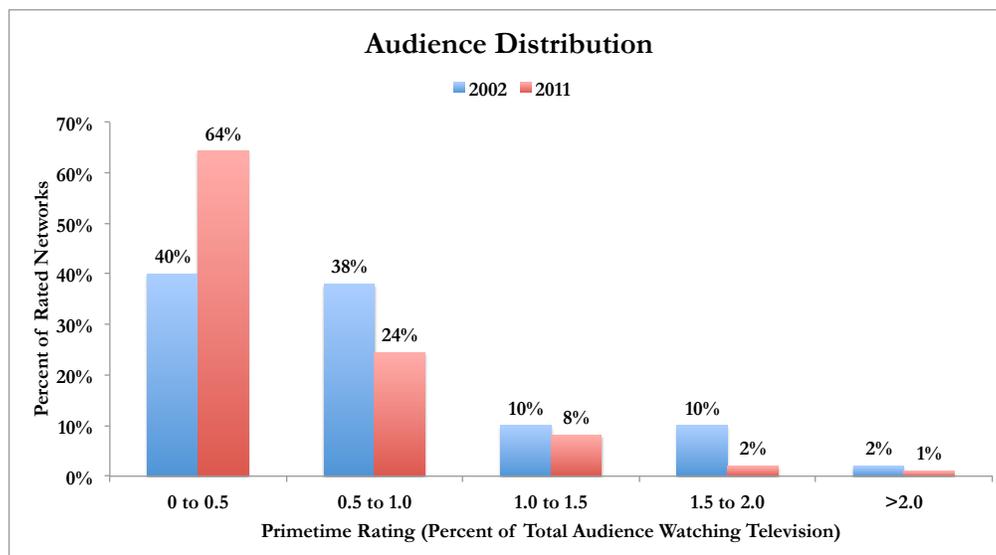
Figure 16:



Sources: Nielsen, Free Press Research

During this time, the number of channels received rose more than 200 percent while the price of expanded basic service more than doubled,³⁷ yet consumers clearly did not demand or watch these extra offerings. Indeed, from 2002–2011, the average number of channels on an expanded basic tier doubled. Yet during this time the number of low-rated channels (with less than 0.5 percent of the audience share) more than tripled, ultimately accounting in 2011 for 64 percent of all rated channels (see Figure 17). And this figure captures only rated channels. There are many more channels consumers are forced to pay for that don't capture enough of an audience for Nielsen to even bother rating.

Figure 17:



Sources: SNL Kagan, Free Press Research

³⁷ FCC data indicate the price for expanded basic service was \$22.35 in 1995. The price had increased to \$49.65 by 2008 (these are nominal dollar values).

The Impact of Sports Networks

The owners of many barely-watched channels charge little for carriage. That relatively low price may offer rate-increase-weary consumers the cold comfort that certain channels don't cost much. Hardly anyone may be watching the Hallmark Movie Channel, but at least its per-subscriber fees are just a couple of pennies a month.

But there are many channels with minuscule audiences that nonetheless demand relatively high license fees from multichannel distributors. And most of these are sports channels offering niche programming that even many sports fans have no interest in watching.

To illustrate this, we calculated each rated channel's value delivered to subscribers. Value is calculated by dividing the channel's total monthly license-fee revenues by the average number of households viewing that channel each day. The channels that charge a high licensing fee relative to their audience size deliver little value to the typical multichannel subscriber, while those with a low licensing fee relative to their audience size deliver more value. Using this metric, we see that nine of the 10 worst value-delivering channels are sports networks (see Figure 18). News Corp.'s FUEL TV, which focuses on extreme sports, has one of the smallest audiences among rated networks, but reaps per-subscriber licensing fees greater than those earned by half of all other rated channels.

**Figure 18:
Best and Worst Value-Delivering Cable Channels**

Network	License Fees Per Subscriber Per month (2011)	Ratings Rank: Total Day (2011)	Monthly License Fee Revenue Per Average Daily TV Households Delivered (2011)
10 Worst Value-Delivering			
FUEL TV	\$0.14	99	\$671
ESPN	\$4.77	7	\$614
NBC Sports Network	\$0.30	82	\$507
Current	\$0.12	98	\$490
NBA TV	\$0.26	88	\$479
NFL Network	\$0.81	56	\$461
MLB Network	\$0.25	83	\$459
Go!TV	\$0.13	100	\$368
ESPNews	\$0.19	76	\$307
FOX Soccer	\$0.17	94	\$292
10 Best Value-Delivering			
Galavision	\$0.03	65	\$25
Lifetime Movie Network	\$0.10	31	\$25
truTV	\$0.11	17	\$22
Cartoon Network	\$0.19	6	\$22
Discovery en Español	\$0.20	79	\$22
TV Guide Network	\$0.02	62	\$18
Investigation Discovery	\$0.07	29	\$15
OWN: Oprah Winfrey Network	\$0.02	54	\$14
Hallmark Channel	\$0.06	25	\$13
Hallmark Movie Channel	\$0.02	57	\$9

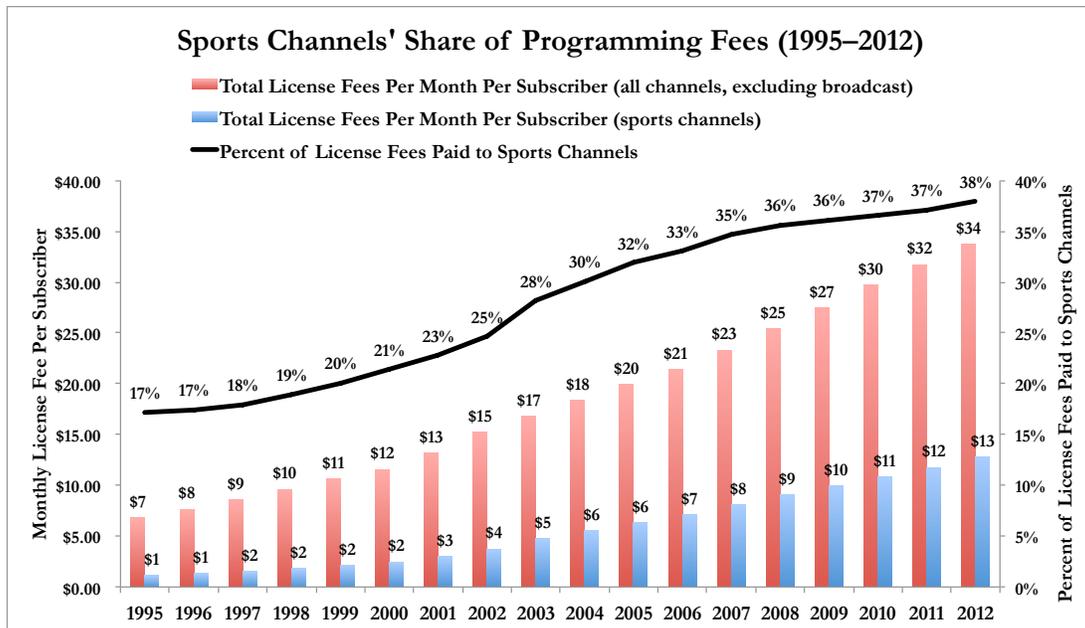
Sources: SNL Kagan, Free Press Research

That a channel like NBA TV can sit at the bottom of the ratings pile yet fetch on average \$0.26 from each and every multichannel subscriber each month is a perfect illustration of the cross-subsidy problem in the current channel-

bundling model. While it's true that every subscriber is cross-subsidizing someone else's viewing preferences,³⁸ sports viewers — and ultimately the sports leagues themselves — are the main beneficiaries of the bundling model.

Barely-watched national and regional sports channels are continually added to the basic tier, and they fetch licensing fees that are far higher than those collected by highly rated channels. This trend is not only the primary driver of monthly cable bill increases, but also means that sports channels are responsible for an increasingly larger share of each subscriber's fees. In 1995, sports channels accounted for 17 percent of the license fees paid to cable programmers. Today that figure stands at 38 percent (see Figure 19).

Figure 19:



Source: SNL Kagan

These data represent the national average, and do not illustrate how the recent proliferation in regional sports networks (“RSNs”) impacts consumers even more in certain media markets. RSNs command licensing fees nearly as high as ESPN’s in some sports-heavy markets like Los Angeles and New York. So it’s not surprising that a Cox executive recently told the *Los Angeles Times* that sports channels account for more than 50 percent of the monthly cable bill paid by the company’s Southern California subscribers.³⁹

Some multichannel distributors are starting to push back against this sports-driven inflation, though not in a way that benefits their customers. Cablevision, Verizon and DirecTV have all added a \$2–3 surcharge to subscribers’ bills

³⁸ For example, the Venn diagram of viewers of niche sports networks and viewers of lifestyle networks may have a small area of overlap, but each group is paying for both categories of channels. The cross-subsidization is not equal here, however, because the size of the audience in one group may be far greater than the other. For example, HGTV’s audience is 72 times larger than FUEL TV’s, yet each network earns the same monthly per-subscriber license fees.

³⁹ Joe Flint and Meg James, “Rising Sports Programming Costs Could Have Consumers Crying Foul,” *Los Angeles Times*, Dec. 1, 2012. (“As a result [of the live appeal of sports programming], cable and broadcast channels that specialize in sports are able to command higher subscriber fees from pay-TV distributors. Walt Disney Co.’s ESPN gets more than \$5 a month for each subscriber, from the systems that carry it, according to the media consulting firm SNL Kagan. Time Warner Cable is getting almost \$4 a month per subscriber for SportsNet. Prime Ticket and Fox Sports West, which [carry] the Angels, together cost about \$5 per subscriber, per month ... The majority of the national and local sports channels are owned by a handful of media giants who like the current system and have the leverage to make distributors accept it.”)

for RSNs.⁴⁰ This surcharge is on top of customers' existing fees, which makes it an unavoidable rate increase for most subscribers. Verizon now also offers a completely sports-free tier, which includes 145 channels for \$50 per month, or a \$15 discount relative to the lowest-priced tier that does include sports networks (210 total channels).⁴¹

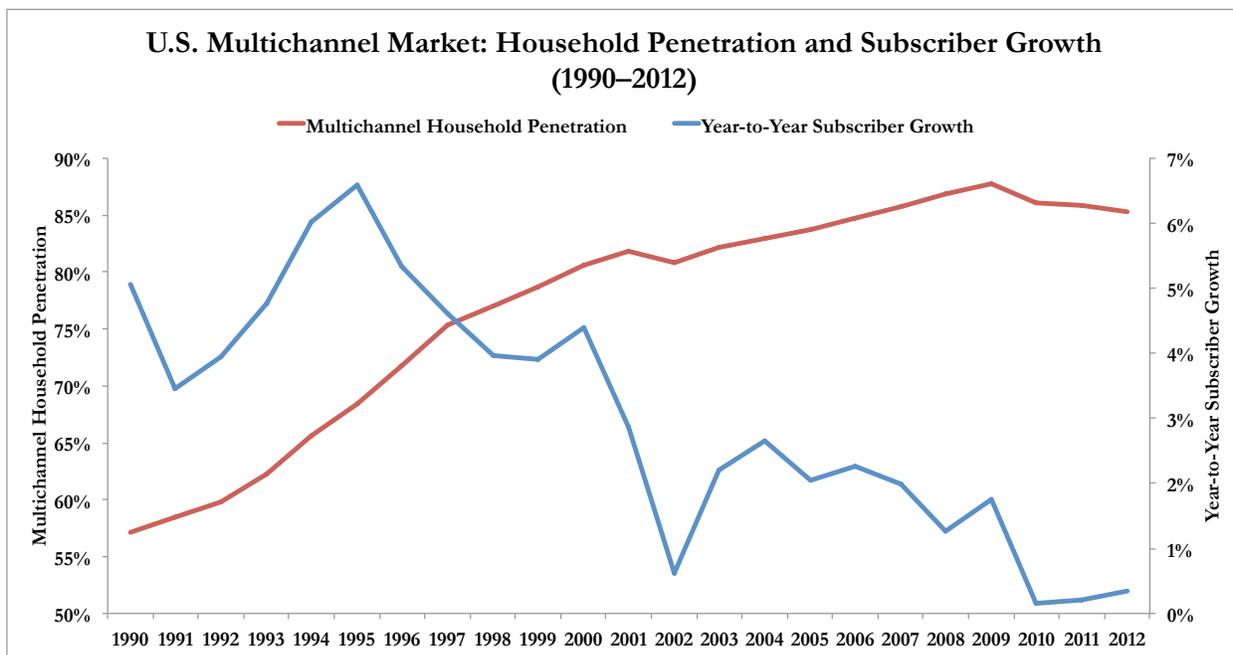
While this non-sports tier may be a welcome alternative to viewers who have absolutely no interest in sports programming, the all-or-nothing approach is not attractive for most consumers. There are likely many consumers who would like to subscribe to a package featuring the marquee sports channels — but none of the niche networks. Not surprisingly, Verizon is thus far silent on the take-rate for this new tier, which may suggest it's more a gimmick than a serious effort to offer consumers the programming they want for a fair price.

Enter the Internet — and a Shift in Viewing Habits

While rising costs from sports and wholesale bundling may threaten the longstanding programmer-distributor cabal, this trend is not likely to progress far or fast as long as vertically integrated companies like Comcast sit at the top of the market and on both sides of the cabal. The real hope for escaping this anti-consumer structure lies in technological innovations. These, combined with the never-ending rate increases in a weak economy, are starting to disrupt the existing video business model.

In 2012, the total number of multichannel video subscribers grew by an anemic 0.3 percent, and growth has been below 1 percent since the end of the recent recession. However, unlike the drop in growth seen in the 2001 recession, this decline does not appear to be ephemeral. Though subscriber growth remains slightly positive, it's not enough to keep pace with new household formation. The percentage of U.S. households subscribing to multichannel services peaked in 2009 at 88 percent, and declined to 85 percent by the end of 2012 (see Figure 20).

Figure 20:



Sources: SNL Kagan, Free Press Research

⁴⁰ Shalini Ramachandran, "Cablevision to Add Sports Surcharge," *Wall Street Journal*, Feb. 21, 2013.

⁴¹ Todd Spangler, "Telco Pitches \$50 Tier With 30 HD Channels for Subscribers Who Don't Care About Sports," *Multichannel News*, Jan. 22, 2013.

The large distributors realize there's not much room for subscriber growth, so they've turned their focus to "new pricing architectures."⁴² In plain English, this means they're going to try and squeeze more money out of their existing customers, in part by offering *less* for the same or higher prices, and by focusing on upselling.⁴³ Indeed, the traditional cable providers saw their total video-segment revenues grow by 8 percent from 2008–2012 despite *losing* 12 percent of their video subscribers during this period. This revenue growth was primarily driven by growth in digital-tier, set-top box and DVR revenues, which increased by 14 percent, 227 percent and 93 percent respectively during this time.⁴⁴

While the distributors may be happy to bleed their customers for all they can, a small but growing segment of consumers is turning elsewhere for its video content. While estimates for the number of so-called "cord cutters" vary, it appears that at least 5–6 percent of U.S. households relies exclusively on a mix of online and over-the-air sources for their video entertainment.⁴⁵

The media have devoted much attention to cord cutters who are dumping multichannel subscriptions for online content. But the real sea change in this market is how all consumers are displacing traditional linear channel viewing with online and time-shifted content.

According to Nielsen estimates, though we are all spending more time in front of a screen, we are watching less live television. And if we look at the specific age demographics, we see a stark difference between youth and everyone else, suggesting a generational change in viewing habits.⁴⁶

For those in the advertiser-coveted 18-to-34-year-old demographic, traditional TV watching accounted for less than 60 percent of total daily screen time, substantially below the level seen in older age groups (see Figure 21). Those in the narrower 18-to-24-year-old demographic spend approximately 30 percent of their daily screen time on the Internet, with more than one-tenth of their total screen time spent watching online or mobile video content.

In the last half of 2012 alone, the time this age group spent watching online video (fixed and mobile) increased by 32 percent, from 16.5 to 21.7 hours each week.⁴⁷ While this trend is strongest among youth, online video is becoming a more significant part of everyone's viewing. For the population as a whole, the time spent watching online video increased by 17 percent, from 11.2 hours each week in the middle of 2012 to 13.1 weekly hours by the end of 2012.

⁴² Time Warner Cable, Inc., Q1 2013 Earnings Call, April 25, 2013.

⁴³ *See id.* ("The first element of the plan is to get, grow, and keep customers at higher ARPU and profitability. As I mentioned on the last earnings call, we implemented a new pricing and packaging architecture in January that's designed to drive greater connect ARPU and profit. It should also generate customers who will be less likely to churn. *We still advertise the same Beacon prices, but the product packages are leaner — lower speeds and fewer channels and features.* Once our Beacon offers get the phone to ring, our in-bound sales reps are trained to help customers select options that are important to them, like faster broadband or DVR. As a result, customers are upsold into packages that better meet their needs. We're trading connect volume for better rate and retention here, meaning that we're seeking to connect higher-ARPU, more profitable, more stable subs, even if that means fewer connects in the near term." (emphasis added)).

⁴⁴ SNL Kagan *Multichannel Industry Benchmarks*.

⁴⁵ Nielsen estimates that 45 percent of the over-the-air-only households also have a high-speed Internet connection. Nielsen says this equates to 5 percent of all households with televisions, but its over-the-air-only estimate of 10 percent of all households differs from SNL Kagan's estimate of 13.6 percent. So, based on these data, potential cord cutters are 5–6 percent of all TV households. This figure is poised to grow primarily from so-called "cord nevers" — youth who are forming their own households but abstaining from subscribing to multichannel video packages in the first place.

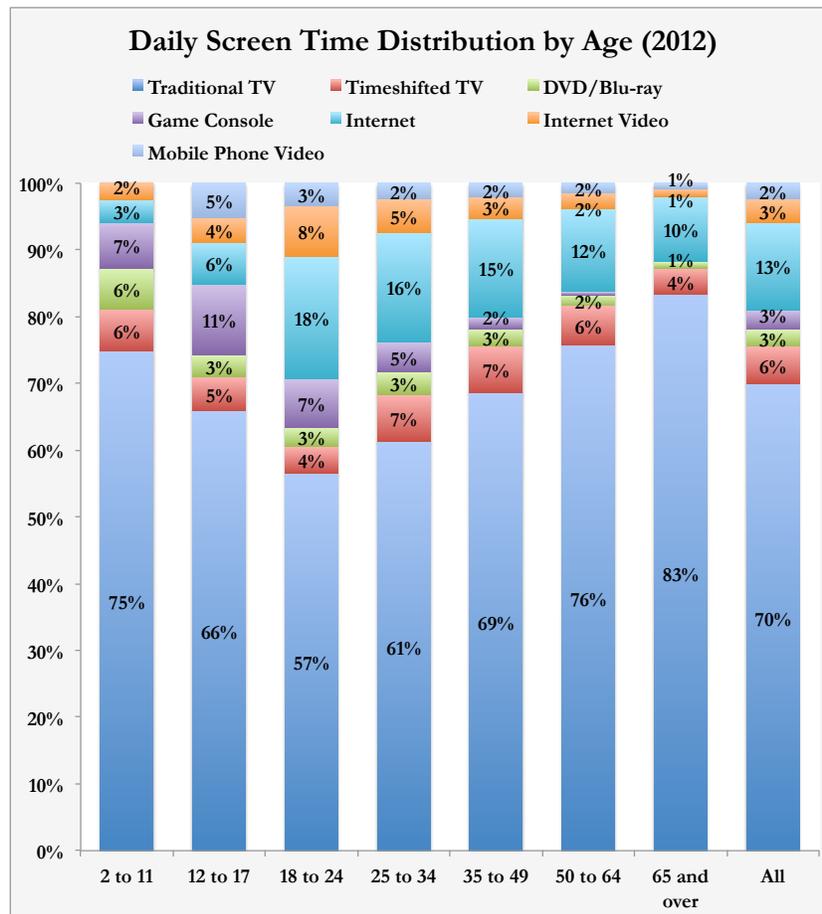
⁴⁶ *See* "The Cross-Platform Report — Quarter 4, 2012 — U.S.," Nielsen Media Research (2012); *see also* "The Cross-Platform Report — Quarter 2, 2012 — U.S.," Nielsen Media Research (2012).

⁴⁷ "The Cross-Platform Report — Quarter 4, 2012 — U.S.," Nielsen Media Research.

Though the traditional TV industry treated cord cutters as mere curiosities for years, they are now a sizable enough faction to warrant more than casual attention. Nielsen has finally decided to include these consumers in its surveys, giving them the misleading label “Zero-TV” households (75 percent of these homes have one or more televisions).⁴⁸

The key question is what is driving these changing habits. Do they reflect a trend among youth, or a permanent shift in consumption patterns that won’t change as these cohorts age? All the early evidence suggests that we might be witnessing a generational shift. Nielsen estimates that half of these cord-cutting households are headed by people under the age of 35, and they don’t appear likely to adopt a traditional subscription multichannel video service anytime soon. Only 18 percent of Nielsen’s Zero-TV homes report that they are considering subscribing to traditional multichannel service, with cost (36 percent) and lack of interest (31 percent) the most-cited reasons for not subscribing.

Figure 21:



Source: Nielsen Cross-Platform Report, Q4 2012

These data reveal that cord cutting is a symptom of larger problems in the video market. These rapidly changing viewing habits illustrate the inflexibility and waste inherent in the traditional multichannel business model. Just as iPods and the iTunes a la carte business model provided an alternative to consumers frustrated with the music industry’s traditional way of doing business, online video is offering rate-increase-weary multichannel subscribers a way of watching at least some of the content they want, where they want and when they want.

⁴⁸ *Id.*

The programmer-distributor cabal's reliance on rate increases only adds fuel to this technology-enabled disruption's fire. It's tempting to view this shift as a natural market evolution that will proceed as Adam Smith's invisible hand intends. However, given the scores of failures in the multichannel market, the pricing power the cabal enjoys, and the threat the cross-subsidy model poses to the proliferation of open broadband, it's clear that any consumer-driven market change will face resistance. No amount of technology can disrupt the status quo if the programmers and vertically integrated multichannel distributors try to thwart the online, over-the-top video-delivery threat to their business model.

Unless policymakers confront the video market's many problems, consumers should expect more rate increases at three times the pace of inflation. Unless Washington gets serious about fostering truly competitive video and broadband markets, consumers looking to online video alternatives should expect an incomplete, cumbersome and ultimately unsatisfying alternative to the status quo. And until policymakers confront the FCC's failure to adequately implement Congress' blueprint for telecom competition embodied in the 1996 Telecom Act, we should gird ourselves for a cable-modem monopoly — and the threat that it poses to our national broadband goals.

PART II: POLICY DISCUSSION

In 1992, consumers were giving Congress an earful about their cable bills.⁴⁹ A decade of deregulation meant cable subscribers had to fend for themselves in a monopoly multichannel market where cable TV companies used their pricing power. A super-majority of Congress took up the cause and enacted the 1992 Act, which noted in its findings that the “average monthly cable rate has increased almost three times as much as the Consumer Price Index since rate deregulation.”

That law, which subjected cable distributors to limited rate regulation on their basic and expanded-basic tiers, was far from perfect. For example, the law's “effective competition” standard does not actually measure whether there is actually *effective* competition. It assumes instead that the mere presence of additional distributors with small market shares would be enough to warrant rate deregulation.⁵⁰ Loopholes like this were inevitable, as the advocates for policy intervention not only needed to win majority support, but also had to secure enough votes to override a veto promised by President George H. W. Bush.

But less than two years after the 1992 law was implemented, many in Congress on both sides of the aisle were lining up to let the cable industry return to its rate-hiking ways. The new members who came into Congress during the 1994 “Republican Revolution” were eager to deregulate, and many Democrats were willing to go along.

Supporters of the 1992 Act were unable to force their colleagues to hold the line on rate regulation. Rep. Ed Markey rightly noted that the law was working exactly as intended. Since the law's implementation, cable rates had declined — a first for the industry (see Figure 22).⁵¹ And though the cable industry claimed that rate caps were harming investment, it turned out this was not the case.⁵²

⁴⁹ See Dissenting Views of Messrs. Markey, Studds, and Klink on H.R. 1555 (1995) (*Markey-Studds Dissent*)

⁵⁰ 47 U.S.C. § 543(l)(1). In general, a franchise area will be deemed effectively competitive if “the number of households subscribing to programming services offered by multichannel video programming distributors other than the largest multichannel video programming distributor exceeds 15 percent,” or a local exchange carrier offers multichannel service.

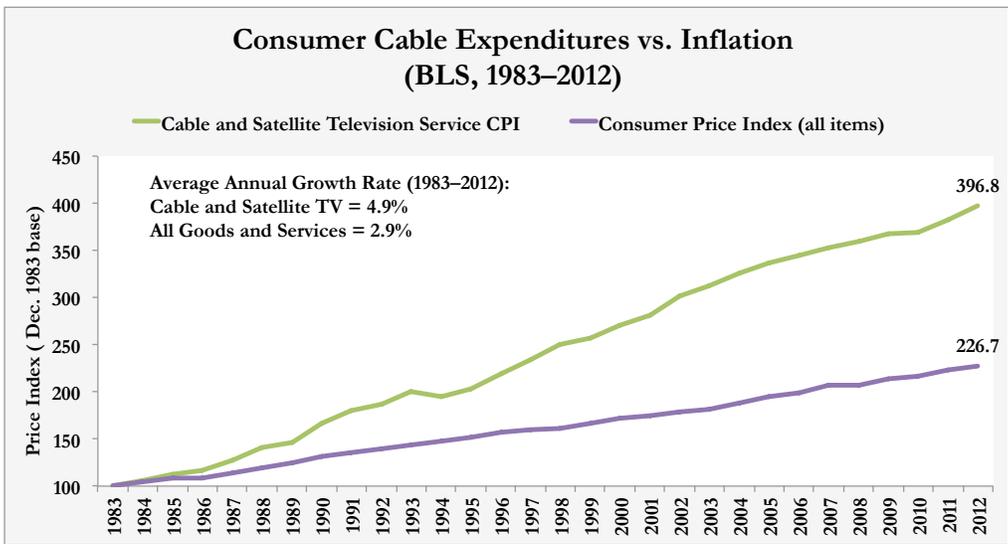
⁵¹ This data from the Bureau of Labor Statistics (BLS) tracks urban consumer spending on cable and satellite television services. Unlike the FCC data collected from cable and satellite providers (presented in Figure 1), it measures what consumers are buying, not necessarily what providers are charging. In other words, the BLS data show a flat line for cable CPI during the recent recession, but the FCC data do not. This is because during the recession consumers cut back on expenditures like cable TV, but multichannel distributors did not cut their prices.

⁵² See *Markey-Studds Dissent*.

But Mr. Markey and other advocates of curbing the cable industry’s monopoly impulses ultimately lost to a very compelling market theory. Many in Congress believed the emergence of new video-distribution platforms — namely satellite and telco — would remove the need for rate regulation. They argued that the additional competition from these distributors would solve the monopoly-pricing problems.

The theory was correct, but incomplete, as it ignored the stumbling blocks posed by vertical integration and the programming industry’s own market power. It didn’t help that the FCC completely bungled the new law’s implementation.

Figure 22:



Sources: Bureau of Labor Statistics, Free Press Research

The History of Multichannel Video Market Regulation

The multichannel television industry came into existence the way many technologies do: A tinkerer hacked a technological solution to a market problem. In this case, the market problem was the failure of over-the-air broadcast television signals to reach remote and mountainous areas of the country.⁵³

The FCC didn’t regulate these early systems, in part because the 1934 Communications Act did not explicitly direct the agency to do so. It wasn’t until the mid-1960s that the FCC, acting on its Title I ancillary authority, began to regulate the cable industry.⁵⁴ These early regulations, ostensibly created to preserve local broadcast services, included must-carry requirements, non-duplication rules and prohibitions on the transmission of distant signals.⁵⁵ The Commission also issued and later modified rules requiring cable systems to provide production facilities for public access programmers and then air the related programming.

⁵³ Though there are multiple claims to the title of the first American community antenna television (“CATV”) system, all of the early systems in the late 1940s and early 1950s were built to address the absence of broadcast TV reception in isolated communities. The cable industry recognizes John Walson as starting the nation’s first CATV system in Mahanoy City, Penn. See “John Walson,” the Cable Center, Cable Center Hall of Fame 2005 Inductees; see also Bob Sullivan, “Cable TV: King of Misleading Come-Ons,” NBC News.com, Jan. 28, 2008 (citing Ed Parson’s 1948 Astoria Oregon system as the first cable TV deployment).

⁵⁴ *United States v. Southwestern Cable Co.*, 392 U.S. 157 (1968).

⁵⁵ See *First Report and Order*, 38 F.C.C. 683 (1968); see also *Second Report and Order*, 2 F.C.C.2d 725 (1969).

The FCC spent much of the 1970s imposing and then later altering or eliminating such regulations for cable systems. These regulations included the same types of carriage requirements and network non-duplication rules, as well as cross-ownership prohibitions, equal employment opportunity provisions, and franchising standards. In 1979, the Supreme Court struck down the FCC's public access requirements (which were based in part on the Communications Act's localism and common carriage principles).⁵⁶ The resulting limbo for these public, educational and government (PEG) channels, and the ongoing confusion about the bounds of the FCC's and local governments' authority over cable systems, finally prompted Congress to act.

The Cable Communications Act of 1984 ("1984 Act") amended the Communications Act of 1934, introducing a new Title VI into the law to govern cable communications services.⁵⁷ The law's purposes included the creation of "a national policy concerning cable communications," the establishment of franchising procedures that "assure cable systems are responsive to the needs and interests of the local community," the assurance that cable systems "provide the widest possible diversity of information sources and services to the public," and the promotion of competition in cable communications.⁵⁸

Though the 1984 Act established specific regulatory obligations for the cable industry, it was essentially a deregulatory bill. Most notably, Section 623(a) of the 1984 Cable Act prohibited the FCC from regulating rates. And monopoly prices followed as soon as Congress signaled to the local cable monopolies that the government would not stop them from charging such prices. Almost immediately, consumers began vocalizing their frustration with cable-rate increases, an outcry that grew only stronger as more than half of all homes adopted cable in the late 1980s.

By the early 1990s, members of Congress could no longer ignore their constituents' pleas for relief. In the summer of 1990, Massachusetts Representative Ed Markey introduced and the House quickly passed the Cable Television Consumer Protection and Competition Act of 1990.⁵⁹ This law, which among other things subjected monopoly cable systems to regulation, was promptly killed in the Senate, thanks in no small part to fierce opposition from the cable lobby.

But consumer outrage grew, and in January 1991 Missouri Senator John Danforth introduced the Cable Television Consumer Protection and Competition Act,⁶⁰ followed shortly thereafter by Rep. Markey's introduction of the House companion bill.⁶¹ The Senate passed an amended version of Sen. Danforth's bill in January 1992 by a vote of 73–18. Markey's companion bill cleared the House on a 340–73 vote in July of that year.⁶² Both chambers quickly overrode President Bush's subsequent veto, with a 74–25 vote to override in the Senate and a 308–114 vote to override in the House.⁶³

The 1992 Act served its primary purpose of holding cable rates in check. After increasing at a level exceeding the rate of inflation for a decade, consumer expenditures on cable television service actually declined from 1993 to 1994 (see Figure 22 above).⁶⁴

⁵⁶ *FCC v. Midwest Video Corp.*, 440 U.S. 689 (1979).

⁵⁷ P.L. 98-549.

⁵⁸ 47 U.S.C. § 521.

⁵⁹ H.R. 5261, 101st Congress, Second Session (1990). Agreed to by House via voice vote.

⁶⁰ S. 12, 102nd Congress, First Session (1991).

⁶¹ H.R. 1303, 102nd Congress, First Session (1991).

⁶² H.R. 4850, 102nd Congress, Second Session (1992).

⁶³ P.L. 102-385 (1992). The final law utilized the rate-regulation and signal carriage provisions contained in the House version, while adopting the retransmission-consent framework contained in the Senate's bill (the House's bill did not address the issue of retransmission consent). *See* H.R. Rep. 102-862 (1992).

⁶⁴ The credit for this decline (as opposed to a more modest increase) goes to the FCC. The agency used its newfound authority under the Communications Act to order that "prices for regulated services of all cable systems be lowered 17

The flaws in the law's effective competition standard, however, ensured that consumers would experience only a brief respite from rate hikes.

Another primary purpose of the 1992 Act was to help satellite TV companies gain access to programming to better compete against cable incumbents. Congress felt that rates were increasing primarily due to cable's monopoly status, and that the introduction of new distribution platforms would change that. Motivated by the need for political compromise, Congress displayed some wishful thinking when it set the standard for how the FCC would determine when a local cable incumbent was subject to effective competition and thus no longer subject to rate regulation.

For example, the 1992 Act's test for effective competition presumes that a local market is competitive if the cable incumbent's market share is below 85 percent. Congress drew this particular *presumptive* line despite the fact that the Department of Justice's own antitrust guidelines presume that distributors still possess pricing power in a market that is so highly concentrated.⁶⁵ Congress also failed to realize that even with the addition of new satellite distributors, the programmers still could exercise their market power, which in the absence of rate caps on the distributors would bring the return of out-of-control price increases.

But with cable policy seemingly settled, in 1993 Reps. Markey and Jack Fields introduced legislation that sought to foster competition in the telecommunications markets through the use of equal access and unbundling policy.⁶⁶ The House enacted the National Communications Competition and Information Infrastructure Act by a vote of 423–4 in June 1994. However, Sen. Bob Dole threatened a filibuster, effectively killing the legislation ahead of the 1994 midterm elections.⁶⁷

After the Republican Party assumed control of both chambers of Congress in early 1995, there was a marked shift in how many members on both sides of the aisle approached cable regulation. Deregulation was the theme of the day, even if this overarching slogan obscured the complexity of the policy choices Congress was considering. While there were a few members who felt that government should play no role in the cable market, the overwhelming majority of both Republicans and Democrats embraced the emerging “competition-then-deregulation” philosophy.

The driving forces behind this shift were the dawn of the broadband telecommunications era in the mid-1990s and the big promises cable, telco and other executives were making about the future of competition. The Regional Bell Operating Companies (“RBOCs”) wanted desperately to get out from under the policies of the court-ordered Modified Final Judgment (“MFJ”) in the AT&T breakup, which kept them from entering the long-distance, video and information-services markets. The competitive telecoms, led by AT&T Corp. and MCI, wanted equal access to the RBOCs' local networks to offer local calling and data services. And the cable industry wanted multichannel service-rate deregulation and approval to enter the local telecom market.

All these factions told Congress that open telecommunications networks would solve any market-power problems in the services offered over those networks. With every home and business in America connected to reasonably priced, fast and open advanced networks, there would no longer be any concern about competition in the local toll, long-distance, information-service and multichannel-video markets. The thinking was that so long as the underlying

percent.” See “FCC Orders Further Rate Reductions While Preserving Incentives for Cable Operators to Invest in New Services,” Federal Communications Commission, press release, Feb. 22, 1994.

⁶⁵ An 85 percent market share, with two equal-sized competitors controlling the remaining 15 percent of the market, equates to an HHI (Herfindahl-Hirschman Index) value of 7,338. In 1992, the DoJ's *Horizontal Merger Guidelines* presumed that a market with an HHI above 1,800 (meaning about 5.5 equal-sized competitors) is highly concentrated, and that firms would possess market power. See “Horizontal Merger Guidelines,” Federal Trade Commission and the U.S. Department of Justice, April 2, 1992.

⁶⁶ National Communications Competition and Information Infrastructure Act of 1993, H.R. 3636, 103rd Congress, Second Session (1993).

⁶⁷ Edward J. Markey, “Electronic Oases Take Root in Mr. Minow's Vast Wasteland,” *Federal Communications Law Journal*, Vol. 55, No. 3 (2003).

telecommunications service was a neutral distribution platform, and new entrants could get into the business of offering these other services over that platform, there would be no concern about the Bells entering the long-distance markets — and no need to regulate cable rates.

The plan's linchpin was cable's promise to become a telecommunications service provider, one that would not merely be an alternative for narrowband voice service, but an open and nondiscriminatory broadband telecommunications service capable of delivering high-quality voice, video and data communications.⁶⁸

With members on both sides of the aisle embracing this competitive theory, Congress moved to loosen some of the cable regulations it had adopted less than three years earlier, regulations that in their first 15 months of existence had already saved consumers \$3 billion.⁶⁹ Though it maintained the 1992 Act's structure for regulating basic cable rates,⁷⁰ the 1996 Telecom Act eliminated rate regulation of all enhanced tiers.⁷¹ The new law also amended Title VI of the Communications Act to deem a local video market competitive as soon as a Local Exchange Carrier began offering video services, regardless of its market share.⁷² And Congress stripped individual consumers of their ability to challenge a rate as unreasonable, reserving that power for the local franchising authority.⁷³

Even though the mantra of the 1996 Telecom Act was “competition before deregulation,” the cable industry got the rate relief it asked for — regardless of marketplace conditions. Not surprisingly, FCC data show that expanded basic cable rates once again began rising annually at three times the rate of inflation, with a sharp uptick in 1999.⁷⁴

Despite all their promises, the Bells did not enter the video markets for another decade (having completely ignored the law's Open Video System provisions that would have enabled entry bypassing the franchise process). And the cable industry broke its promise to become the competing nondiscriminatory broadband platform. Cable instead pressured the FCC to create a loophole in the regulatory structure by defining cable's two-way telecommunications platform as an information service and not a telecommunications service. The Commission did this — even though Congress clearly stated that “telecommunications services [include] the transport of information or cable services”⁷⁵ when it adopted the 1996 Telecom Act.

⁶⁸ See Telecommunications Competition and Deregulation Act of 1995, Report of the Committee on Commerce, Science, and Transportation on S. 652, S. Rpt. 104-23, 104th Congress, First Session (1995) at 13 (*Senate Committee Report on S. 652*). (“Decker Anstrom testified that NCTA supports telecommunications legislation because the cable industry is ready to compete, and legislation must include rate regulation relief for cable. *He said that cable will be the competing wire to the telephone industry, and cable's coaxial cable carries 900 times more information than telephone's twisted copper pair.* The problem, he said, is that cable does not have the capital or, in some states, the authority to compete with the local exchange carriers.” [emphasis added])

⁶⁹ See *Markey-Studds Dissent*.

⁷⁰ Small cable systems, however, were deregulated even on basic tier rates. See 47 U.S.C. § 543(m).

⁷¹ The FCC's ability to regulate these “upper” tier rates sunset on March 31, 1999. See *id.* § 543(c)(4).

⁷² *Id.* § 543(l)(1)(D).

⁷³ *Id.* § 543(c)(1)(B).

⁷⁴ From 1998 to 1999, expanded basic rates increased by 3.8 percent. From 1999 to 2000, these rates increased by 7.9 percent. In contrast, from 1999 to 2000 the rates for basic cable increased by 2.1 percent. See *FCC 2012 Cable Price Survey* at Table 3.

⁷⁵ See *Senate Committee Report on S. 652*. (“As defined under the 1934 Act [as amended by this bill], ‘telecommunications services’ includes the transport of information or cable services, but not the offering of those services. This means that information or cable services are not included in the definition of universal service; what is included is that level of telecommunications services that the FCC determines should be provided at an affordable rate to allow all Americans access to information, cable, and advanced telecommunications services that are an increasing part of daily life in modern America. Put another way, the Committee intends the definition of universal service to ensure that the conduit, whether it is a twisted pair wire, coaxial cable, fiber optic cable, wireless, or satellite system, has sufficient capacity and technological capability to enable consumers to use whatever consumer goods that they have purchased, such as a telephone, personal computer, video player, or television, to interconnect to services that are available over the telecommunications network.”).

This history is as important today as it is forgotten. Congress created the correct framework for the blossoming of competition in the voice, video, data and information-services markets. But the FCC, abetted by the courts, quickly abandoned this framework.

By tossing aside the congressional roadmap, the FCC led us to what we all live with today: multichannel service prices that continue to skyrocket despite the decline in traditional cable's market share; an at-best duopoly market for wired telecommunications; and the potential end of the entire concept of a public telecommunications service network, and with it any hope for the competitive nirvana Americans were promised in 1996.⁷⁶

However, the law itself remains intact. The answers to solving the problems in both the video market and the broadband market are there. The question is whether the new leadership at the FCC has the desire and the political will to get the Act back on track — even if it means picking a fight with the American cable and telecom industries.

Hidden Prices: The Tie That Binds the Cabal

Any serious discussion of what policies are needed to remedy the video market's problems must start with an accounting of the market's failures. The evidence presented in Part I of this paper shows the failures are legion.

There isn't enough viable competition to discipline the market power enjoyed by large programmers and distributors, which hike prices without any fear of losing profits. Both sides in this increasingly distrustful union use contractual obligations to keep the cabal together, erecting artificial entry barriers for new players and restraining trade that would otherwise occur in a free market.

Large programmers tie unpopular channels to marquee channels, crowding out capacity and financial resources for independent channels. Principal-agent problems ensure that consumers have little sovereignty when it comes to translating their demands into the products available in the market. Distributors use broadband (a product subject to very little competition in a market with insurmountable entry barriers) to cross-subsidize their high-revenue video business. Some large distributors like Comcast actually use predatory pricing (e.g., selling a video-data bundle for less than the price of stand-alone data service) to discourage competition from new video providers. And some distributors also use data caps and veiled threats against Internet openness to thwart competition from over-the-top competitors.

But hidden prices are perhaps the most tangible sign of a failed market. Distributors sell inflexible, more-than-you-can-eat programming bundles full of linear channels that span numerous genres and are procured at vastly different prices from programmers. This model completely obscures actual consumer demand, making consumers appear to be far less price sensitive than they actually are for any given channel or group of channels. These hidden prices ensure that efficient market equilibrium is never reached: Supply can never satisfy demand because consumers aren't allowed to express that demand.

Just as the business traveler with an expense account probably buys more surf-and-turf dinners than are needed, and the doctor orders far too many expensive tests for a patient, cable distributors are willing to accept the programmers' increasingly unreasonable terms because the distributors' customers absorb them, and those customers have no sovereignty or meaningfully competitive alternatives.

Indeed, the economic problems hidden prices create are exacerbated in highly concentrated, oligopolistic markets. Consider the credit-card market, where the duopoly card providers force merchants to hide the interexchange fees paid to the card companies on every non-cash transaction. These fees, which are set at a level far above what would be expected in a competitive market, are hidden and thus passed along to all consumers regardless of whether or not

⁷⁶ See Comments of Free Press, *In the Matter of AT&T Petition to Launch a Proceeding Concerning the TDM-to-IP Transition; Petition of the National Telecommunications Cooperative Association for a Rulemaking to Promote and Sustain the Ongoing TDM-to-IP Evolution*, GN Docket No. 12-353, Jan. 28, 2013.

they use credit cards, debit cards or cash.⁷⁷ Card-carrying consumers might be less likely to set down the plastic if they could see the interexchange fee and avoid it by paying cash. This transparency in turn could force the credit-card providers to charge an interexchange fee that is more closely related to cost than the current monopoly-level fees.⁷⁸

The presence of hidden monopoly-level fees in the credit-card fee market spurred Congress to act.⁷⁹ The same issues exist in the multichannel market, but since programmers and distributors alike benefit from these hidden costs, the calls for reform are not as loud as they were in the credit-card case (where merchants expressed their concerns). Now, as we discussed above, the programmers may be pushing the smaller distributors too hard, and cracks are starting to show in the cabal model. But these cracks are small and will remain so in a market where vertical integration is rampant.

Hidden prices are the reason programming costs are escalating exponentially. Hidden prices mean ESPN doesn't think twice about increasing the licensing fees it pays to Major League Baseball from \$350 million to \$700 million a year.⁸⁰ Hidden prices are why Time Warner Cable was willing to pay a mediocre baseball team \$320 million a year for the next 25 years for the right to broadcast its games.⁸¹ Hidden prices are why we have college football coaches earning an average of \$1.64 million a year.⁸² They are why the average NFL player's inflation-adjusted salary has increased more than 700 percent in the last three decades.⁸³

And they are why a channel like Lifetime can lose two-thirds of its audience while maintaining a profit margin nearly three times that earned by Exxon Mobil.⁸⁴

The Bloated Bundle Business

The multichannel video market's hidden prices thrive because of the bundled channel business model. But bundles aren't inherently bad; what's harmful is the lack of choice offered among these multichannel bundles. Cable customers are essentially given a choice between very little and far too much. They can take a \$20 basic bundle that includes (by law) all local broadcast stations, along with any PEG channels. If they want something more, they have

⁷⁷ Andrew Martin, "How Visa, Using Card Fees, Dominates a Market," *New York Times*, Jan. 4, 2010.

⁷⁸ Scott Schuh, Oz Shy, and Joanna Stavins, "Who Gains and Who Loses from Credit Card Payments? Theory and Calibrations," Federal Reserve Bank of Boston, Public Policy Discussion Papers, No. 10-03, Aug. 31, 2010.

⁷⁹ P.L. 111-203 ("Dodd-Frank Wall Street Reform and Consumer Protection Act").

⁸⁰ "ESPN Deal Shows Power of MLB with TV Suitors," *USA Today*, Aug. 28, 2012.

⁸¹ Richard Sandomir, "Sweet TV Deal Will Taste Bitter to Fans," *New York Times*, Jan. 28, 2013.

⁸² Erik Brady, Steve Berkowitz, and Jodi Upton, "College Football Coaches Continue to See Salary Explosion," *USA Today*, Nov. 20, 2012. ("The average annual salary for head coaches at major colleges [not including four schools that moved up to the Football Bowl Subdivision this season] is \$1.64 million, up nearly 12% over last season — and more than 70% since 2006, when USA TODAY Sports began tracking coaches' compensation.").

⁸³ In 2011, the average NFL player earned \$1.9 million, up from \$90,000 in 1981, or \$223,000 in 2011 dollars. That is a real value (not nominal) increase of more than 700 percent during the past 30 years. By comparison, the average wage per worker was \$14,144 in 1981 (\$35,000 in 2011 dollars) and was \$41,211 in 2011, an increase of just 18 percent. See Joe Dorish, "Average Salaries in the NBA, NFL, MLB and NHL," *Yahoo Sports*, Nov. 12, 2011. See also "Average N.F.L. Salary Is \$90,102, Survey Says," *UPI International*, Jan. 29, 1982. Data on the average wage per worker was obtained from the Social Security Administration's Average Wage Index.

⁸⁴ SNL Kagan estimates the Lifetime Network earned a cash-flow margin of 34.6 percent in 2012. Exxon Mobil's cash-flow margin in 2012 was 12.02 percent.

to subscribe to the expanded basic tier, which delivers an average of 124 channels for almost \$60 per month,⁸⁵ a price that doesn't even include the now-mandatory cable box.⁸⁶

In a competitive market, this all-or-little approach would not survive. It'd be like walking into your local deli and learning your only choices were a ham sandwich on rye, or a sub with every kind of meat, cheese, topping, bread and condiment imaginable.

Since 1995, the average number of channels on an expanded basic tier has tripled, and so too has the monthly price.⁸⁷ This increase doesn't mean consumers were clamoring for more seldom-watched networks like VH1 Classic or the Golf Channel. It's because the large programmers force the distributors to place these low-demand networks on the most popular expanded basic tier if those distributors also want to carry the highly watched channels.

And the distributors are more than happy to facilitate this bloating of the basic tier. Traditionally, they didn't need to worry about the resulting higher prices pushing their customers to a competitor, because the programmers force these same bloated bundles on every cable, satellite and telco multichannel service provider. For the larger distributors, basic bloat has been nothing but great business. As prices go up, so do profits and the all-important Average Revenue per User ("ARPU") metric that is the focus of Wall Street's attention.

But as discussed above, the programmers are now accruing the lion's share of the benefits from this once mutually beneficial business model. Because of that, some distributors are fighting back. Cablevision is suing Viacom over its channel-tying contracts. Verizon is contemplating using set-top-box ratings data as an indicator for what it actually should pay to carry certain channels, and the company is offering a lower-priced sports-free bundle. Time Warner Cable is openly considering including antennas in its set-top boxes to gain leverage in retransmission-consent negotiations with local broadcasters.⁸⁸ And some small cable system operators are actively contemplating exiting the video market altogether.

But what we aren't seeing yet is any of the cable multichannel distributors openly contemplating competing outside of their incumbent cable system markets. Cable distributors like Comcast, Time Warner Cable and Cablevision all own some of their own programming and have deep relationships with other programmers. Thus they are well positioned to compete as "Virtual Multichannel Video Programming Distributors," or V-MVPDs, by offering an "over the top" ("OTT") video-subscription package that users could access via any broadband connection. Indeed, this was the kind of competitive future the cable industry promised in exchange for the deregulation it received in the 1996 Telecom Act.

The explanation for why we don't see incumbent cable distributors competing as V-MVPDs out of market is complex, but several factors are key.

First, the technologies needed to support this business model only recently became a market reality. The latest FCC data indicate that 57 percent of all fixed-line high-speed Internet connections have advertised downstream speeds

⁸⁵See *FCC 2012 Cable Price Survey* at Table 3.

⁸⁶ This is now the case because the FCC let the cable industry evade the policies designed to protect consumers from this exact outcome. See Rob Pegoraro, "Tip: Why You Need a Box for Basic Cable," *USA Today*, April 14, 2013.

⁸⁷See *FCC 2012 Cable Price Survey* at Table 3.

⁸⁸ Cecilia Kang, "Time Warner Cable CEO Wants to Slim Cable Bundles, Eyes Aereo's Technology," *Washington Post*, May 2, 2013. Multichannel Video Programming Distributors are required by law to offer a basic tier that includes local broadcast channels. But if the broadcaster elects to exercise its retransmission-consent rights, and the distributor and broadcaster fail to agree on the carriage price, the distributor is not required to carry the channel. Under normal conditions this sort of blackout would bring more economic harm to the distributor, which loses an in-demand channel its competitors carry. But if the distributor's subscribers were able to access the broadcast station via an antenna in the cable box, presumably in a manner that appears identical to the normal delivery method, the broadcaster loses substantial leverage in any retransmission-consent negotiation.

above 6 megabits per second (Mbps), the level of bandwidth needed for a high-quality video stream.⁸⁹ In addition, to deliver a service that is as high-quality and seamless as a traditional MVPD product, the virtual provider needs a distributed network architecture that stores content as close as possible to the end user, and it needs a robust IPTV platform that can handle authorization, security, ad insertion and content-delivery optimization. While the technological barriers remain for some, independent OTT distributors like Netflix have largely solved the problems associated with delivering a high-quality on-demand video stream to just about any kind of Internet connection.

Another reason traditional cable companies have yet to compete out of market is fear of setting off a price war with other distributors, which could result in cannibalization of their high-revenue video business. Since it owns NBCU's content, Comcast may be best positioned to launch a V-MVPD product that reaches the 55 percent of U.S. households Comcast's wired cable systems do not currently serve. But if it did begin competing out of market it would certainly spur the other cable distributors to offer their own services to the 53 million homes located in Comcast's traditional service territory.⁹⁰

However, the changing economics of video distribution may finally result in some cable distributors seeing more benefit than risk in launching a V-MVPD service. As discussed above, cable distributors' video margins are in decline, as are their numbers of subscribers. Wall Street likes to see growth, and investors may be willing to accept the lower margins on video triggered by a V-MVPD price war in exchange for subscriber growth, certainly as long as these cable system operators remain the dominant players in their broadband markets.

But the incentives needed to push traditional cable companies to compete out of market are not there yet. While cable holds on to the traditional distribution model, new over-the-top entrants are trying to make a go of it in the market. However, while these new distributors are the subjects of an endless amount of media attention, none has emerged as a viable alternative to the traditional multichannel services. Indeed, even Netflix positions itself as a complement to traditional cable, just another premium channel on the already-swollen lineup.⁹¹ While this posturing may just be an example of going along to get along, it reflects the immense structural barriers to true over-the-top competition.

Vertical Integration, Old and New: The Key Barrier to Disruption

Vertical integration is a key barrier to video competition — and one that has long been the focus of communications and antitrust regulators. Comcast, the nation's largest cable distributor, controls two dozen basic cable networks, two broadcast networks, and nine regional sports networks. Other cable system owners control lucrative regional sports networks, or have stakes in basic cable channels. This vertical integration helps these distributors mitigate the impact of programming-cost increases, but it also creates an incentive to withhold programming from competing distributors.

⁸⁹ Only 20 percent of residential DSL connections have advertised speeds exceeding 6 Mbps, compared with 80 percent of cable-modem connections. *See* Internet Access Services: Status as of Dec. 31, 2011, Industry Analysis and Technology Division, Wireline Competition Bureau, Federal Communications Commission, February 2013, Figure 3(a) and Table 10.

⁹⁰ Tom MacIsaac, "The Television Industry Re-Made: The Rise of the Virtual Cable Company," *Business Insider*, April 20, 2010.

⁹¹ *See* Netflix Long-Term View, Netflix Inc., April 25, 2013 ("We don't and can't compete on breadth with Comcast, Sky, Amazon, Apple, Microsoft, Sony, or Google. For us to be hugely successful we have to be a focused passion brand. Starbucks, not 7-Eleven. Southwest, not United. HBO, not DISH."). *See also* Yinka Adegoke and Lisa Richwine, "Exclusive: Netflix in Talks for Cable Partnership," *Reuters*, March 6, 2012 ("Netflix Chief Executive Reed Hastings has quietly met with some of the largest U.S. cable companies in recent weeks to discuss adding the online movie-streaming service to their cable offerings, according to sources familiar with the matter. In what would ratchet up its competition with HBO, the talks could lead to Netflix becoming available as another on-demand option for cable subscribers through their set-top boxes, according to three people familiar with the talks.").

Concerns about vertical integration led Congress to enact the program-access provisions in Section 628 of the Cable Act. When Congress first legislated on this issue in 1992, traditional cable distributors controlled 95 percent of all multichannel subscribers and were affiliated with half of all national cable networks.⁹² Today the prevalence of this form of vertical integration is far less than it was two decades ago, with the exception of Comcast's ownership of NBCU, and the ownership of regional sports networks by Comcast and other cable distributors. This decline in vertical integration prompted the FCC in 2012 to end its preemptive exclusivity ban, while maintaining a process for case-by-case review of any exclusivity complaints.⁹³

But despite the decline in the pervasiveness of vertical integration, program access remains a critical barrier to competition. Indeed, both AT&T and Verizon have filed program-access complaints with the FCC, claiming competitive harms from traditional cable distributors' withholding of must-have sports channels.⁹⁴ Over-the-top distributors have filed program-access complaints against traditional cable distributors as well as programmers affiliated with traditional distributors.⁹⁵ The FCC has refused to address these issues with any haste,⁹⁶ standing by as new entrants go out of business and send a chilling signal to any potential investors in independent, OTT multichannel distributors.⁹⁷

While the incentives traditional vertical integration creates remain a barrier to entry for competing distributors (particularly when it comes to accessing cable-owned RSNs), another form of vertical integration is now the primary roadblock to a new video service business model. Distribution has always been integrated with the multichannel bundle. It had to be, since there was no alternative delivery path. The law did not treat cable systems as common carriage networks, and thus content was tied to delivery. The same is true for satellite. Other than broadcast, the box office or home video, programmers and other aggregators of content had no alternative for reaching consumers. This necessity gave rise to the programmer-distributor cabal.

The possibility of disintermediation of programming *distribution* from *transit* never existed prior to the widespread availability of open, high-speed data networks. But now that broadband reaches most of the country, the concerns about vertical integration and the incentives it creates are different. If *transit* exists as its own market distinct from multichannel video programming *distribution*, then the policy concerns about vertical integration change. There is still concern about the withholding of distributor-owned content from other distributors, but it pales in comparison to the incentive that cable system owners now have to thwart their programming partners from working with competing over-the-top distributors.

Both programmers and the traditional distributors view over-the-top distribution as a threat.⁹⁸ Programmers realize that if there is a significant market for programming purchasing, it could over time disrupt their ability to pass along

⁹²See H.R. Rep. 102-628 (1992).

⁹³*In the Matter of Revision of the Commission's Program Access Rules*, Report and Order, 27 FCC Rcd 12605 (2012).

⁹⁴See, e.g., *AT&T Services, Inc. and Pacific Bell Telephone Company d/b/a SBC California d/b/a AT&T California v. Cox Enterprises, Inc. and Cox Communications, Inc.*, Program Access Complaint (Sept. 11, 2008).

⁹⁵See, e.g., *In the Matter of the Complaint of Sky Angel U.S., LLC Against Discovery Communications, LLC, et. al. For Violation of the Commission's Competitive Access to Cable Programming Rules*, Program Access Complaint, MB Docket No. 12-80(Mar. 24 2010).

⁹⁶The FCC is still deciding what it even means to be a "channel" or a "multichannel video programming distributor" under the law and its rules. See *Media Bureau Seeks Comment on Interpretation of the Terms "Multichannel Video Programming Distributor" and "Channel" as Raised in Pending Program Access Complaint Proceeding*, Public Notice, 27 FCC Rcd 3079 (2012).

⁹⁷See *VDC Corporation v. Turner Network Sales, Inc., et al.*, Program Access Complaint (Jan. 18, 2007); *VDC Corporation v. CBS Broadcasting Inc.*, Good Faith and Exclusive Retransmission Consent Complaint (Jan. 25, 2007); *VDC Corporation v. John Doe 1 Cable Operator, et al.*, Program Access Complaint (Jan. 26, 2007)

⁹⁸See, e.g., Jim Salter, "Charter Refuses Ads for TV Antenna Maker," Associated Press, March 21, 2013.

continued rate increases and their bundled “take-it-or-leave-it” model. Indeed, this is the driving force behind the development of TV Everywhere and the programmers’ strategy of selling only reruns to online distributors.⁹⁹

On the other side, the distributors obviously enjoy higher margins when the distribution market is a tight oligopoly. These economics give traditional distributors strong incentives to discriminate and engage in market foreclosure — raising concerns that lie at the heart of the Network Neutrality and data-cap debates.

In sum, there are numerous problems in the video markets, and substantial barriers to disruption. The key question is what can be done to break down these barriers — and enable the video market to function like a truly free one.

PART III: POLICY OPTIONS

The video market is a mess. There are no good options for consumers who just want to pay a fair price to watch the content they want, where they want and when they want. And their complaints, which Washington once took seriously, now fall on deaf ears.

The governing policies contained in Title VI of the Communications Act were well intended and are still relevant, but there is no denying that the market has evolved in ways Congress never foresaw. The Cable Act (as amended in 1992 and 1996) was designed to make it possible for satellite and telco distributors to enter the market and compete with traditional wired cable providers. And they did. But now we’ve gone from one to in some cases five multichannel distributors (with the cable incumbent having only a plurality of the market share). And yet this increase in the number of providers is doing nothing to keep down prices or spur innovation in the video-distribution market.

The programmers clearly possess pricing power and deserve a hefty share of the blame for the sorry state of today’s video market. But unlike network operators, programmers do not use public rights of way or public airwaves, and the barriers to entering the programming market (aside from the sports-programming market) are comparatively low.

Thus, policies that break the programming-distribution cabal’s collective market power must first focus on the traditional distributors, as their businesses are built using public lands and resources.

We could have a serious discussion about returning to rate regulation. In theory, if the law constrained the distributors’ ability to pass along exorbitant programming-cost increases to their customers, they would have no choice but to say “sorry” to the programmers, who in turn would have no choice but to say “sorry” to the monopoly sports leagues and production studios. This discussion would start with an examination of the flaws in the 1992 Act’s definitions of effective competition, definitions that measure the number of competitors but not whether they are actually competing. We could contemplate pegging the effective competition standard to the

⁹⁹ Indeed, this is why programmers have made heavy use of the “windowing” model when dealing with online distributors, to extract as much revenue out of the market as possible. *See, e.g.*, Julianne Pepitone, “Netflix Scores Cartoon Network, Adult Swim and More Time Warner Content,” *CNN Money*, Jan. 14, 2013 (“Time Warner, like many cable-content titans, was initially leery about licensing content to streaming services like Netflix. Instead, the company pushed hard on an initiative it announced with Comcast in 2009: ‘TV Everywhere,’ an authentication system that lets users watch TV online by signing in with credentials proving they pay for a cable service. While Time Warner remains a champion of TV Everywhere, it says it now thinks the service can live side by side with Netflix and other streaming subscriptions. ‘The industry has evolved so that TV Everywhere and subscription video on-demand services can coexist with the appropriate windowing strategy,’ Deborah Bradley, Turner’s senior vice president of program acquisitions, said in a written statement. ‘Windowing’ is the film and TV industry jargon for carefully timing — and delaying — the release of content through various viewing channels. The goal is to maximize revenue from the sales of hot, in-demand programming.”).

Department of Justice's Horizontal Merger Guidelines, which would show the multichannel market far exceeding the "highly concentrated" threshold that indicates market-power abuses and coordination are likely.¹⁰⁰

But even under ideal circumstances, it's inherently difficult to regulate rates. In this case it may ultimately be futile considering that the production inputs (programming) are demonstrably the sole source for rate inflation.

So what can be done to make the video market work more like an actual free market — one where consumers are sovereign and innovation is unshackled from an anachronistic and rigid market structure?

We already have an answer. It's the same one that prompted Congress to overhaul our nation's communications laws in 1996, and it's the same one that's driving what little disruption we're currently seeing in the video market.

Congress Was Right: Big Open Pipes Are the Answer

The main purpose of the 1992 and 1996 amendments to the Cable Act was the creation of competition in the monopoly multichannel video-distribution market. Though there was sharp disagreement on the precise role government should play, there was nearly unanimous consensus that government should create a more competitive video market.

Almost every single member of Congress who opposed cable rate regulation still did not take the position that unfettered monopoly was acceptable (though a few did express the opinion that since cable wasn't a necessity, the government had no business intervening in the market). They simply believed competition was preferable to regulation, and the law was meant to foster competition.

For example, Rep. Billy Tauzin was a strong opponent of rate regulation, but an equally strong supporter of program-access regulations, which he viewed as necessary to ensure that satellite distributors could compete.¹⁰¹ For members like Mr. Tauzin, the 1992 Act's redeeming quality was its enabling of a new delivery platform — satellite — to enter the market and compete. And for most members of Congress, especially those who reversed their stance on rate regulation, the entire point of the 1996 Act was the creation of robust and open telecommunications platforms that could deliver competitive voice, video and data services. The theory Congress operated on in 1996 was that more distribution mediums (be they copper, coaxial cable, fiber, terrestrial wireless or satellite) equals competition — competition in the markets for the services delivered over those distribution mediums.

Well, it turns out we have this wonderful thing called the Internet. It's a platform that comes into nearly everyone's home, but only via the traditional public switched telecommunications network, the coaxial wires used by the cable system, or another physical distribution medium. And *if* the Internet remains an open and nondiscriminatory platform, like it has always been, then anyone can be a video distributor — not just the satellite, cable and telecom incumbents that own the physical infrastructure.

But thanks to the FCC's foolhardy classification decisions, there is no guarantee that the Internet will remain a viable delivery platform for new video distributors. When the owners of the physical infrastructure can prevent anyone else from being a distributor, that's a problem. When that same owner also owns the content that new video distributors would need to compete, we have an even worse problem on our hands.

¹⁰⁰ If the product market were defined as the multichannel subscription market, the average local market would have an HHI of approximately 4,000 (cable's national share is 56 percent, satellite's is 34 percent split between two firms, and telco has a 10 percent share, though a limited geographic presence). If the product market definition were more expansive (including over-the-air-only households), the HHI would be closer to 3,000, still in excess of the DoJ's threshold of 2,500 for a highly concentrated market.

¹⁰¹ See, e.g., Remarks of Rep. Tauzin on Conference Report on S.652, Telecommunications Act of 1996, House of Representatives, Congressional Record, p. H1151, Feb. 1, 1996.

The answer to the video market's problems is to throw money at it. If venture capitalists in pursuit of a better video-bundling business model throw money at the programmers, the programmers will play ball. Over time, this investment could produce new video business models where supply more closely matches demand.

But this investment and innovation will not happen if there is any uncertainty about the openness of the delivery platform. While American Internet Service Providers ("ISPs") all claim to embrace openness, their actions tell a different story. When ISPs embrace data caps and overage charges that serve no legitimate engineering or economic purpose, they send a signal to the market that scarcity, not abundance, is the business model. Artificial scarcity is a market failure, one that depresses investment and deprives Americans of the benefits of technological progress.

So the answer to this complex problem is the one we came up with so long ago. We don't need public policy to dictate how the industry should behave; that's the consumers' job. We need public policy to allow innovation to happen. If we keep the pipes open, the content will flow and consumers will win.

The unfortunate reality is that while we already have these policies and they are the law of the land, the FCC abandoned them. The FCC's shortsighted classification decisions robbed Americans of both a competitive broadband market and a competitive video market.

As discussed above, satellite distributors have not been able to compete effectively with the cable companies because they cannot offer a broadband product. If the FCC had not abandoned its line-sharing and open-access policies, today we would likely see companies like DISH and DirecTV offering competitively priced double- and triple-play product bundles as Competitive Local Exchange Carriers ("CLECs") or with CLEC partners.

The cable and telco incumbents have spent a substantial amount of resources red-baiting the issue of reclassification. This is unfortunate, because Congress' blueprint for competition outlined in the 1996 Act was the right one, and members of both parties supported it, as did the cable and telecom incumbents and their would-be competitors.

The 1996 Act was framed as deregulation in exchange for competition. Though we've already got the law we need, it may be time to consider this approach again. If cable and telco transmission were affirmatively put back under Title II (where Congress already put it), there might not be any need for much of Title VI. To be clear, this would require Congress to preserve the funding for the public, educational and government programming that the market will not provide. And it would also require Congress legislating a *Trinko* fix to ensure antitrust could actually serve as a useful consumer-protection tool.¹⁰²

Other Policies to Promote Video Market Competition

Big open pipes are the central component to creating a more competitive video market, as they will be the platform for a better video-distribution model. Programmers will be more comfortable over time stepping outside of the current cabal once OTT distributors come en masse with generous bids for programming rights. And the OTT investment will come once these new entrants are confident that their businesses can reach consumers via a robust, nondiscriminatory broadband platform.

But we need to protect consumers while this natural market evolution takes place. And we need to give the programmers a push in the right direction, ensuring they have incentives to sell programming to a wider variety of distributors.¹⁰³ Therefore, in addition to ensuring the big open pipes are available, policymakers need to focus on other policies that would correct existing market failures and make the video market work better for consumers.

¹⁰² *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko LLP*, 540 U.S. 398 (2004).

¹⁰³ We do not address in this paper policies that would create a so-called "duty to deal" for the programmers, and one that could put new over-the-top distributors on more equal footing with traditional pay-TV providers. But this option also comes

Policies that give consumers the option to build their own bundles would push the market in the direction consumers want it to go in. Giving consumers a la carte pricing options, alongside traditional bundled packages, would allow people to express their preferences and would shine light on the true prices of channels currently hidden in the bundle. And though channel owners might initially set a la carte prices substantially higher than the current per-subscriber wholesale price, market forces over time would compete down a portion of these supra-competitive prices and their corresponding upstream costs.

Policies that stop programmers from illegally tying unpopular channels to must-have networks would also discipline the market power the larger programming firms enjoy. This “wholesale unbundling” policy would enable distributors to experiment with more flexible and diverse bundled channel offerings and ultimately bring relief to subscribers paying bloated prices. In an encouraging development, Sen. John McCain recently introduced legislation that tackles the wholesale-bundling problem and creates incentives for distributors to offer a la carte options.¹⁰⁴

The FCC should also uphold its promise to enforce its program-access rules, and extend the benefits of these policies to online-only distributors. The agency should address complaints with speed, as any delay will only harm investment in new innovative distributors.

The Commission should also require multichannel distributors to report the per-channel price they pay for programming. Once consumers get a clearer picture of where their money is going, they will be more vocal about their dissatisfaction with the current more-than-you-can-eat bundled business model.

One of the most-discussed recommendations from the National Broadband Plan was the idea to create “Allvid,” a cable-box replacement that would act as a one-stop gateway for traditional MVPD content as well as over-the-top alternatives.¹⁰⁵ The cable industry predictably rejected the idea because it fears what could happen if consumers had OTT options listed side by side with their multichannel services. If the FCC is serious about promoting broadband adoption and video competition, it should implement this recommendation.

Finally, the idea floated by companies like Verizon to better measure what consumers are actually watching is a good one that could help push the programmers into reconsidering their current forced-bundle model. But the larger programmers will resist this effort and may resort to the use of contracts to ensure it never happens. Thus policies are needed to guarantee that distribution contracts are not used to prevent the collection and dissemination of such information.

CONCLUSION

Consumers are tired of the semiannual cable-rate increases, which are now as inevitable as death and taxes. We love our TV, but we’re not getting the choices we deserve and we’ve got no satisfying alternative to the bloated, traditional linear multichannel business model.

American investors and entrepreneurs stand at the ready, willing to disrupt the stagnant video market. But the structural barriers to competition and the market power programmers and incumbent distributors enjoy are strong. This broken market structure restrains competition and depresses investment. Consumers, as always, are the biggest losers in this rigged game.

with the difficult task of identifying the right rate, something that is far more complex in the video sector than it is in the music sector (where the royalty debate is far from settled).

¹⁰⁴See S. 912, 113th Congress, First Session (2013) (“A Bill to allow multichannel video programming distributors to provide video programming to subscribers on an a la carte basis, and for other purposes.”).

¹⁰⁵See “Connecting America: The National Broadband Plan,” Federal Communications Commission, pp. 49-52 (2010).

Congress used to care about monopoly harms. But now that those harms remain in the absence of a rigid monopoly, our policymakers just throw up their hands.

The Internet offers a solution to this seemingly intractable problem. It is the one platform to rule them all, enabling limitless competition in all markets that used to be viewed as permanent monopolies, including video distribution.

But though incumbents promised and Congress legislated a future of big, open, nondiscriminatory and competitive telecommunications networks, the FCC redefined this promise into oblivion. Where we used to have at least one open telecom network (and were promised the immediate appearance of a second), we now have none. The infrastructure monopolies haven't disappeared. We have just collectively decided to pretend they don't exist.

This is about much more than video entertainment. By ignoring the problems in the broken video and telecom markets, policymakers are leaving billions of dollars in economic surplus on the table and robbing Americans of the tens of thousands of new jobs that a small business-led innovation revolution would create by disrupting the old order.

It's time for policymakers to stop listening to the lobbyists, and start studying the history and law. We solved this problem already. The law is written. We just need to implement it.